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ABSTRACT

The report contains legal studies on important tax code provisions related to philanthropic giving. This is Volume IV in a five volume series examining the relationship between nonprofit institutions and their donors. Seventeen papers comprise the report. Tax code provisions which are discussed include eligibility for tax exemption; distinctions between public and private charities; donor's income tax deduction, including property gifts and split interest gifts; charitable bequest deduction; and voluntary services. Data are presented on the dimension of charitable giving under the estate tax, the gift tax, and fiduciary income tax. Policy alternatives are discussed on estate tax incentives. Nontax government alternatives to tax incentives are considered, including matching grants to institutions and direct grants to beneficiaries rather than institutions. The scope of local property tax exemption and related issues are examined. (Author/AV)

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3. That income deducted for charitable giving should be excluded from any minimum tax provision.
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4. That the appreciated property allowance within the charitable deduction be basically retained but amended to eliminate any possibility of personal financial gain through tax-deductible charitable giving.
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5. That the charitable bequest deduction be retained in its present form.

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6. That corporations set as a minimum goal, to be reached no later than 1980, the giving to charitable purposes of 2 percent of pre-tax net income. Moreover, the Commission believes that the national commission proposed in this report should consider as a priority concern additional measures to stimulate corporate giving.

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1. That all larger tax-exempt charitable organizations except churches and church affiliates be required to prepare and make readily available detailed annual reports on their finances, programs, and priorities.

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2. That larger grant-making organizations be required to hold annual public meetings to discuss their programs, priorities, and contributions.

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3. That the present 4 percent "audit" tax on private foundations be repealed and replaced by a fee on all private foundations based on the total actual costs of auditing them.

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Part I

Exemption and Deduction

CRITERIA FOR EXEMPTION UNDER SECTION 501(c)(3)

John P. Persons,† John J. Osborn, Jr.† and Charles F. Feldman†

Introduction and Summary of Report

Section 501 (a) of the Internal Revenue Code exempts from federal income tax organizations described in section 501 (c) (3) as follows:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

In addition to being exempt from tax, all such organizations (except those engaged in testing for public safety) are eligible to receive gifts and bequests that are deductible in computing the income, gift, and estate tax liabilities of the donors.

Because of the tax benefits that flow from qualification under section 501 (c) (3), the vast majority of philanthropic organizations conduct themselves in accordance with the criteria for exemption provided in that section. Thus, section 501 (c) (3) to a large extent determines the limits of philanthropic activity in this country.

This report explores the history of the statutory criteria and describes the manner in which they have been interpreted by the courts and the IRS. It thus provides a background against which to consider the broad question of whether the criteria for exemption are adequate in light of the role of philanthropy in our society. Aside from the question of restrictions on legislative activity, which is dealt with in a report to the Filer Commission by John B. Huffaker, it is our conclusion that it would be generally impracticable to delineate the statutory criteria any more precisely than is now done in section 501 (c) (3), although statutory solutions to specific problems may be appropriate from time to time.

"Charity" is the most important concept contained in section 501 (c) (3), and also the most difficult to define. Its legal origins may be traced back to the 1601 Statute of Charitable Uses in England. Over the intervening centuries a number of broad categories of recognized charitable activity have emerged, including the relief of poverty, the advancement of education, religion and science, the promotion of health, and the lessening of the burdens of government. A comprehensive definition has never been formulated, however, and the authorities now agree that to do this would be impossible. Charity is an evolving concept which must be allowed to change and expand in response to the needs of society.

The requirement of flexibility is recognized by both the IRS and the courts. Both have avoided confining the concept of charity within a rigid mold. The evolution of the scope of "charity" under section 501 (c) (3) has been a frequent source of controversy. In cases where the existing precedents do not clearly indicate whether or not an organization is charitable, the result would appear to be influenced primarily by the following considerations: (1) Does the organization meet a recognized need of the community that would not otherwise be met through the functioning of the commercial market? (2) Are the means used by the organization to achieve its charitable purposes reasonably related to the needs it is seeking to meet? (3) Does the organization serve the public interest as distinguished from a private or "selfish" interest? (4) Is the organization's program consistent with law and public policy? If an organization can answer "yes" to all of these questions, a means will probably be found to conclude that it is "charitable." But if the answer to any one of these questions is in the negative, the organization is unlikely to be accorded the tax benefits that accrue to a "charitable" organization.

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The IRS has not attempted to formulate a definition of "religion" for the purposes of section 501 (c) (3). The concept of religion developed by the Supreme Court in cases involving other federal statutes and the First Amendment appears to be applicable and to provide in most cases a generally workable test for purposes of section 501 (c) (3). Under this test, religion does not require a belief in God but encompasses any sincere and meaningful belief which occupies in the life of the possessor a place parallel to that filled by the God of traditional religious faiths. There are, of course, difficult borderline cases that continue to arise, but they do not appear to be susceptible to a legislative solution.

"Education" is defined in IRS regulations as a process of training or instruction in which subject matter useful to the individual and beneficial to the community is presented in a sufficiently objective manner to enable the recipient to evaluate it and come to an independent judgment. A multitude of diverse organizations have been recognized as "educational" by the IRS under this regulation, and the concept is relatively uncontroversial.

"Scientific" is defined in the regulations as including research carried on in the public interest, the results of which either are available to the public on a nondiscriminatory basis or otherwise benefit the public. This regulation appears to have resolved most of the practical problems that arose prior to its promulgation.

The other exempt purposes referred to in section 501 (c) (3) – testing for public safety, literary purposes, and prevention of cruelty to children or animals – are of comparatively limited application and have not presented major problems.

Since law and philanthropy are constantly in flux, it is only natural that at any given time unresolved problems will exist as to the scope of section 501 (c) (3). Most commentators seem to agree that the existing statute unduly restricts the freedom of many philanthropic organizations to engage in activities intended to influence legislation in furtherance of their exempt functions. Indeed some commentators have asserted that such restrictions are unconstitutional. Proposals under consideration in Congress to modify the restrictions on influencing legislation are discussed in Huffaker's report to the Commission.

The principle that 501 (c) (3) organizations must act in conformity with public policy can raise difficult questions for the IRS because of the uncertainty, or even controversy, that sometimes exists as to the scope and effect of such policy. For example, although the IRS has recently required that, as a condition of qualifying under section 501 (c) (3), private educational institutions adhere to the national policy against racial discrimination by following nondiscriminatory admissions policies, some observers have expressed the view that the IRS should have taken this action at an earlier date. In the absence of definitive judicial or legislative guidance, the IRS must of necessity act in each case on the basis of its own judgment as to the policy issues involved.

Philanthropic organizations are often required to accomplish their charitable or other exempt purposes by carrying on activities that closely resemble those of organizations in the commercial sector. In some of these situations the position of the IRS may be unduly restrictive. For example, experience may demonstrate that the restrictions imposed by the IRS upon the ability of charitable public interest law firms to receive fees for their services are not justified and should be modified. The same may also be true of the IRS position denying 501 (c) (3) status to cooperative entities formed by colleges (or other 501 (c) (3) organizations) to meet their needs for specialized administrative services. By the enactment of sections 501 (e) and (f) Congress has recognized the desirability of granting 501 (c) (3) status to some of these cooperative entities, and there is also judicial support for this position. It would seem that such treatment could appropriately be extended administratively to other similar situations that are not covered by the precise terms of sections 501 (e) and (f).

Health care is another area in which the criteria for exemption have not been definitively established. The criteria currently provided by the IRS with respect to hospitals are being challenged in the courts, and the IRS has not yet published its position with respect to so-called "health maintenance organizations." The resolution of these questions may require the formulation of new criteria under section 501 (c) (3) in recognition of the vast changes that have occurred in recent years with respect to the financing and provision of health care.

Under the present statutory and administrative structure, a heavy burden of responsibility falls upon the IRS. Although the determinations of the IRS are subject to judicial review, only in the unusual case will an organization be either inclined or able to engage in the extended, expensive litigation which a resort to federal courts entails. Thus, the IRS usually has the last word as to questions of exemption under section 501 (c) (3). While there is undoubtedly disagreement as to positions taken by the IRS in individual cases, our study indicates that on the whole the IRS has been responsive to the changing needs of society in its administration of that section.

I

HISTORICAL ORIGINS OF SECTION 501 (c) (3)

The most important concept that underlies section 501 (c) (3) is the concept of "charity." In its popular sense, charity has been described as "the impulse to give service, gifts, hospitality, friendship."[1] This impulse is inherent in human nature and was expressed in the daily life of primitive society long before charity emerged as a part of the legal system. Within primitive society the sense of mutual obligation among the members of a family or clan was strong:

> Generally speaking, almsgiving was not common among primitive peoples because there was little need for it. There were no "poor" in the modern sense; needs were the elemental ones for food, clothing, and shelter, and these were supplied through the family or the clan – unless all went hungry and shelterless. To belong to a numerous family was to have aid to dependent children, maternity benefits, unemployment insurance, home relief, what medical care was available, fire insurance, an old-age annuity, and free burial.[2]

On the other hand, those outside the particular primitive group were regarded with indifference, and it has been noted that "the growth of civilization may be judged by the extent to which the obligations of philanthropy have spread to include those whose fate was previously a matter of indifference – the slave, the poor, the barbarian, the enemy."[3]

As the obligations of philanthropy broadened, it became necessary for government to adopt increasingly complex laws to deal with philanthropic organizations. As these laws have developed, governmental law-making bodies have been concerned with charity in four principal ways. These may be stated in the form of questions: (1) What activities should be considered charitable? (2) What legal institutions and rules are needed to enable charity to accomplish its objectives? (3) How should charity be regulated in order to guard against abuses? (4) Should charity be taxed and, if so, how?

The legal history of charity consists of the efforts of lawmakers to find answers to these four questions as they have arisen at various times over several centuries. These answers have been greatly influenced by the attitude of society toward charity and the degree to which society has felt that charity should be encouraged through the legal system. Since so much of the American law of charity has its roots in England, this Chapter will first review the history of English law as it relates to these four aspects of charity. It will then review the legal history of charities in America. A paper by Chauncey Belknap discussing the rationale for exempting charities from tax is appended to this report.

The Development of the Legal Definition of Charity in England

The English Statute of Charitable Uses, enacted in 1601 near the end of the reign of Elizabeth I, contained the first comprehensive definition of charitable purposes. The Statute is generally regarded as the starting-point of the modern law of charity. However, for many centuries prior to 1601 Englishmen had been making gifts and bequests for so-called "pious causes." During the Middle Ages the Roman Catholic Church, through its ecclesiastical courts, had exclusive jurisdiction over all testamentary dispositions and expected its members to leave a portion of their wealth to the church in order to insure their salvation.[4] Scholars who have studied the wills of this period report a heavy emphasis upon this theme of "salvation at a price."[5] The pious causes that were customarily selected included the saying of masses and prayers for the dead, the maintenance of lamps and tapers before altars, the establishment of chantries, the provision of alms for the poor, and the building and endowment of churches – generally "anything of a holy nature to keep away the devils which were supposed to surround the dying and the dead."[6]

As the Middle Ages came to a close, the pious bequests included in wills became more secular. Henry Allen Moe has commented upon the appearance around the year 1362 of William Langland's poem, *The Vision of Piers the Plowman.* Dr. Moe states that this "poem was in its day, and for centuries afterwards, of the greatest intellectual and practical significance."[7] In one of the episodes of the poem, "Truth" sends a letter to wealthy merchants advising them that in order to save their souls they should take their fortunes,

> and therewith repair hospitals
> help sick people
> mend bad roads
> build up bridges that had been broken down
> help maidens to marry or to make them nuns
> find food for prisoners and poor people
> put scholars to school or to some other crafts
> help religious orders, and
> ameliorate rents or taxes.[8]

Studies of the wills executed in England around the time of *Piers the Plowman* and thereafter confirm the increasing preference of testators for the types of secular good works enumerated in that poem.[9] Dr. Moe believes that the poem reflected and influenced the social thinking of the period that followed it. Accordingly, when the Statute of Charitable Uses was enacted more than 200 years later, it was natural for the draftsmen to formulate the statutory definition of charity in terms strikingly similar to those found in Langland's poem.

This definition is set forth in the preamble of the Statute, which reads (in modern spelling) as follows:

> Whereas lands, tenements, rents, annuities, profits, hereditaments, goods, chattels, money and stocks of money have been heretofore given, limited, appointed and assigned as well by the Queen's most excellent Majesty, and her most noble progenitors, as by sundry other well-disposed persons; some for relief of aged, impotent and poor people, some for maintenance of sick and

> maimed soldiers and mariners, schools of learning, free schools and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea-banks, and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen, and persons decayed; and others for relief or redemption of prisoners or captives, and for aid or ease of any poor inhabitants concerning payments of fifteens, setting out of soldiers and other taxes; . . .[10]

While this preamble is commonly referred to as a definition, it is in reality an enumeration of purposes which were at the time regarded as charitable. This enumeration was not intended to be all inclusive. The preamble "did not attempt to mark out the limits of legal charity or condemn as non-charitable those uses which were outside its letter and equity."[11] One area that was given only token attention in the preamble was religion. The omission of all religious purposes (except the repair of churches) was intentional. England had only recently completed its Reformation, and as a consequence the Crown had dissolved the monasteries, taken over the religious foundations, and confiscated the assets of numerous trusts which had theretofore been established for religious purposes but were held (after the Reformation) to be "superstitious" and therefore void. The distinction between religion and superstition was not clear, and the draftsmen feared that the inclusion of activities dedicated to religious purposes "might infect by association other charitable uses, whose endowments the Crown could then appropriate."[12]

The 1601 Statute had two objectives. The first was fulfilled by the preamble, the specification of the important purposes that were considered to be charitable under the law. The second was to reform the administration of charity. As will be discussed hereafter, this objective was to be achieved by the establishment of a system of commissioners to inquire into and rectify abuses such as maladministration, negligence, or diversion of charitable funds. Only the charitable purposes enumerated in the preamble were within the jurisdiction of the commissioners. However, because the Statute was remedial in nature, the accepted view was that it should be generously construed to protect those endowments that had been established for the public benefit.

A history of the period states that "[p]ublic benefit was the key to the statute, and the relief of poverty its principal manifestation."[13] The 1601 Statute was enacted as a supplement to the comprehensive system of poor laws adopted by Parliament in 1597 and restated in 1601. Professor W.K. Jordan states that this system "was essentially prudential, having been drafted and passed by a government which liked to be fore-armed against all emergencies and which had been seriously frightened by the distress and the attendant disorders just prior to the convention of Parliament in 1597."[14]

Under the 1597 legislation, responsibility for the relief of poverty was placed primarily upon the local communities, which were given power to levy and collect taxes for this purpose. The central government made it clear that it would not intervene so long as each local community met its responsibilities in its own way. Professor Jordan states:

> The immediate, and perhaps the expected, consequence of the passage of this great *corpus* of legislation was a notable increase in the flow of private charitable funds designed to provide relief for the truly derelict and to attack the whole problem of poverty frontally by creating institutions which would effect its cure. . . . The state stood poised for intervention after 1597, if the need should arise, but because of the prodigal generosity of private men who had assumed for themselves an heroic burden of social responsibility that intervention was in fact to be long delayed. . . .[15]

The Report of the Committee on the Law and Practice Relating to Charitable Trusts (published in England in 1952) sums up the legislative developments of 1597-1601 as follows:

> Thus a partnership was established, in which the state filled in gaps left by charity rather than charity filling in gaps left by the state. ...
>
> The important point to notice ... is that state action and voluntary action were not the antithesis of each other; rather they sprang from the same roots, were designed to meet the same needs and had the same motivating forces behind them ...[16]

For over a century after the enactment of the 1601 Statute of Charitable Uses, the task of defining charity did not present a difficult problem for the English judiciary. The character of philanthropy did not depart significantly from the categories of charitable activity comprehensively listed in the preamble, which was liberally construed in accordance with its basic intent.[17]

However, by 1736 a reaction had set in against the steady increase in charitable land holdings. Parliament passed in that year a Mortmain Act which voided devises of land to charity and vested the property so devised in the testator's heirs or next-of-kin. The motivation behind the Act was anti-clerical, but the impact of the statute was not restricted to ecclesiastical charities. The temper of the times is indicated by the following extract from the Parliamentary debates:

> I am very far, my Lords, from disapproving of all charitable foundations, or of all donations to charitable uses, either by will or deed; but I am convinced that our charitable foundations may become too numerous, and that some of those we have already established, may become too rich and extensive ... for, by the specious pretence of charity, the solicitations of those who are interested in charitable foundations, and the pride and vanity of donors, it is to me highly probable, that too great a part of the lands in this kingdom may soon come to be in Mortmain, to the prejudice of the nation in general, and to the ruin or unjust disappointment of many a man's poor relations ...[18]

Under the 1736 Act, by classifying a devise of land as charitable, the judges could insure that the land would not pass to charity but to the testator's heirs, thus effectuating the intent of the Act.[19] On the other hand, because the 1736 Act applied only to devises of land and not to bequests of personalty, in cases of the latter type the courts could protect the testator's heirs only by holding that the bequest was not charitable.[20] The conflicting decisions that resulted from this situation introduced uncertainty and confusion into the English law of charity, which had not previously been seriously troubled by the problem of definition.

In 1805 more confusion was generated by the decision in *Morice* v. *Bishop of Durham.*[21] There, the Chancellor, Lord Eldon, held that only purposes set forth in the 1601 Statute of Charitable Uses, or purposes analogous thereto, were charitable in the eyes of the law. This was a retreat from the earlier view that the 1601 Statute was not an exclusive touchstone of legal charity but merely an enumeration of the types of activities that were at that time considered charitable. The effect of Lord Eldon's decision was to make "charity" a word of art whose meaning could be discovered only by reference, or analogy, to the "chart" set forth in the 1601 Statute. However, the decision failed to give succeeding English judges a clear policy as to how they were to use this chart in the resolution of new cases.

An effort at achieving an orderly synthesis of the decisions was made in 1891 by Lord Macnaghten in the following famous passage from *Commissioners of Income Tax* v. *Pemsel:*[22]

> "Charity" in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads . . . . The trusts last referred to are not the less charitable in the eye of the law, because incidentally they benefit the rich as well as the poor, as indeed, every charity that deserves the name must do either directly or indirectly.

Although this passage is more of a classification than a definition, it does contain the unifying concept of "other purposes beneficial to the community." However, this did not succeed in resolving the problems of the judiciary, as indicated by the following statement by Lord Sterndale 30 years later:

> I . . . am unable to find any principle which will guide one easily, and safely, through the tangle of cases as to what is and what is not a charitable gift. If it is possible I hope sincerely that at some future time or other a principle will be laid down. The whole subject is in an artificial atmosphere altogether. A large number of gifts are held charitable which would not be called charitable in the ordinary acceptance of the term, and when one takes gifts which have been held to be charitable, and compares them with gifts which have been held not to be charitable, it is very difficult to see what the principle is on which the distinction rests.[23]

More recently, George Keeton has written that the experience of the English judiciary in attempting to define charity is "probably the worst exhibition of the operation of the technique of judicial precedent, which can be found in the law reports."[24] Accordingly, the definitional problem was ripe for consideration by the Committee on Charitable Trusts (commonly referred to as the "Nathan Committee" for its chairman, Lord Nathan) which was appointed by Prime Minister Atlee in 1950 "to consider and report on the changes in the law and practice (except as regards taxation) relating to charitable trusts in England and Wales which would be necessary to enable the maximum benefit to the community to be derived from them."[25]

The appointment of the Nathan Committee grew out of the vast expansion of government social services in England following World War II. As a result of this expansion, governmental programs were extended into many areas previously occupied by private charity. In [illegible] cases government assumed the complete financial burden. An example is the Royal Surgical Aid Society, which in 1948 supplied 13,000 surgical appliances and in 1949 only 635.[26] These developments raised a concern as to whether the purposes of many charitable trusts had become obsolete and also whether the legal definition of charity should be modified in the light of changed conditions.

The committee was "urged on the one hand to devise language which will be 'flexible' and will accord with modern social and economic conditions and on the other to introduce a greater element of precision and certainty and thereby reduce the risk of litigation and of the founder's wishes being defeated."[27] The committee noted in its report that these objectives are "largely incompatible." It observed that

> . . . any attempt to define the meaning of charity exhaustively, that is, by an enumeration of all charitable objects, would be both impracticable and wrong in principle – impracticable because the enumeration would almost certainly prove incomplete from the outset and wrong in principle because, so far from leaving the control of charity flexible and responsive to changes in the structure of society, it would fix it in a rigid mould.[28]

Thus the Nathan Committee gave first priority to the idea that the content of charity should be "flexible and responsive to changes in the structure of society." In order to achieve this the committee concluded that

> . . . the law must continue to be judge-made and that it is a complete delusion to suppose that to start with a clean slate would reduce the number of difficult cases or the volume of litigation. On the contrary, the elaborate and expensive process of building up case law would, as it seems to us, start all over again.[29]

For these reasons, the committee proposed that the preamble of the 1601 Statute of Charitable Uses be repealed and that there be enacted in its place a new "definition" based upon Lord Macnaghten's classification in the *Pemsel* case, but preserving the case law intact. The committee said it hoped that this approach would "give somewhat more freedom to the judiciary in applying the well-established principles of the existing law to the problems of an age of rapid and continuous change."[30]

Even this modest proposal, however, was not fully adopted by Parliament. In the legislation[31] that resulted from the committee's study, the preamble to the 1601 Statute of Charitable Uses was finally repealed, but Parliament declined to go further and enact a new statutory definition of charity based upon Lord Macnaghten's classification. Thus, the task of defining charity remained with the English courts, unaided by any statutory expression of the governing rules or principles.

The English Origins of Special Legal Institutions and Rules Developed to Enable Charity to Accomplish Its Objectives

The first charitable institutions in England were the ecclesiastical foundations, which, it has been estimated, owned between one third to one half of the public wealth of that country by the time of Henry VIII (1509-47).[32] However, secular charitable institutions also existed (such as the Oxford and Cambridge colleges), and charitable functions were performed by the guilds.

As part of the long struggle of the Crown to curtail the power of the Church, beginning in 1215 various Mortmain statutes were enacted that limited the right of charitable corporations to hold land. Finally, during the reigns of Henry VIII and Edward VI, the supremacy of the Crown was established by the dissolution of the ecclesiastical foundations and the confiscation of their property.

While this struggle was going on, the trust (or use) began to emerge as an alternative form of conveyancing. The trust enabled a landholder to circumvent the rigid rules of feudal tenure, and also the limitations of the Mortmain statutes. At first, such uses were not enforceable at law, but by the mid-fifteenth century the Court of Chancery was exercising its equity powers to protect the beneficiaries of trusts and to compel trustees to perform their duties.

W.K. Jordan has shown that during the period 1480-1660 about two thirds of all gifts for charitable purposes were made by will,[33] many in the form of trusts for religious purposes. Prior to the Reformation, the ecclesiastical courts had exclusive jurisdiction of testamentary matters, and they used this jurisdiction to develop special rules for the protection of trusts for religious purposes. These rules were subsequently applied by the Court of Chancery to charitable trusts for nonreligious purposes, which were established in increasing numbers from the fifteenth century onwards.[34]

As stated in Tudor on Charities, "the privileged position which charitable gifts still retain in the law of wills and trusts is due, no doubt, to the origin of such law in Courts presided over by ecclesiastics."[35] These courts "were anxious to ensure that philanthropy should be encouraged and that the objects of charitable trusts should not be frustrated by the formalism and rigidity of the common law."[36]

This was accomplished by conferring three related privileges on charitable trusts (and no other trusts): (1) the privilege of perpetual existence, which involved exemption from the rule against perpetuities; (2) the privilege of being held a valid trust, even if the testamentary provisions establishing the trust were stated in such general terms that the trust would ordinarily have been held void; and (3) the privilege of having the purposes for which the trust was established changed by court order if the purposes laid down in the original trust deed could no longer be carried out (that is, the *cy pres* doctrine).[37]

It is interesting to note that one of the most urgent questions faced by the Nathan Committee was whether the *cy pres* doctrine should be relaxed in order to make it easier for outdated charitable trusts to obtain new purposes.[38] The committee recommended that this be done, and legislation to accomplish this result was included in the Charities Act which was enacted by Parliament in 1960.[39]

Marion Fremont-Smith has pointed out that historically in England the trust (rather than the corporation) has been the predominant form of organization for charitable activities.[40] A principal reason for this appears to be that "the state was the source of power to create corporations whereas the creator of a charitable trust was afforded great freedom."[41] It was not until the second half of the nineteenth century that Parliament passed a series of acts that permitted general incorporation for certain purposes, including charitable purposes. David Owen reports that during the nineteenth century the growing practice of meeting social needs through the associated efforts of many individuals led to the creation of large numbers of voluntary associations,[42] most of which, we may assume, adopted the corporate form.

At present the English law does not appear to make any sharp distinction between charities organized as trusts and those organized as corporations. Thus, a devise of land to a charitable corporation without any expression of trust "was held equivalent to a devise upon a charitable trust."[43] The Charities Act of 1960 defines a "charity" as any institution, corporate or not, that is installed for charitable purposes.[44]

The English History of the Regulation of Charities to Prevent Abuses

The 1601 Statute of Charitable Uses was entitled "An Act to redress Misemployment of Lands Goods and Stocks of Money heretofore given to Charitable Uses." Under the substantive provisions of the 1601 Statute, commissions in each county were appointed by the Chancellor to inquire into "any breach of trust, falsity, nonemployment, concealment, misgovernment or conversion" of trusts established for the charitable purposes enumerated in the preamble. Thus, the 1601 Statute was the first legislative step in the continuing process of devising regulatory mechanisms to prevent the misuse of charitable funds and institutions.

Under the 1601 Statute the commission procedure was elaborate, involving a hearing before the commissioners and a jury of 12 men at which all interested persons could appear and give evidence. The jury then issued its inquisition, or decision, upon which the commissioners based their decree. The powers of the commissioners were "generally as extensive as the evil demanded." Appeal lay to the Chancellor who could affirm, annul, or reform the decrees of the commissioners.[45]

Gareth Jones states that "[t]he success of this procedure was immediate, and the years before the Civil War were distinguished by a thorough investigation of the administration of charitable trusts."[46] He also points out, however, that the commission procedure was cumbersome and depended for its success upon the willingness of citizens to make a personal sacrifice by serving as jurors and commissioners and also upon the support of the government and the Chancellor's acting promptly upon appeals. After an initial period of success, those persons whose efforts were necessary to insure its effective functioning became indifferent and the commission machinery fell into disuse by the end of the seventeenth century.[47]

The "information" then became the preferred means of regulating charitable trusts. In this proceeding, a private individual instituted a suit in equity in the name of the

Attorney General against the charitable trustees. For the first few decades after the enactment of the 1601 Statute of Charitable Uses, the information could be used only to enforce uses that were not covered by the preamble of the statute. By the end of the seventeenth century, however, the scope of the information was extended to include any charitable use.[48]

As an enforcement mechanism the information proved grossly inadequate, primarily because of the "interminable delays and crushing expense" to which an individual was exposed if he brought suit in Chancery to correct an abuse by charitable trustees. As stated by Sir Samuel Romilly in one of the Parliamentary debates:

> It would be difficult to find a man so public-spirited as to advance a great sum of money to carry on a cause in which he had no personal interest, imputing gross mis-conduct to a neighbour, with a chance of recovering a part of his expenses after so great a lapse of time.[49]

Reformers were forced to look again to Parliament for a solution. In 1818 and 1819 laws were enacted that provided for the appointment of Parliamentary commissions to investigate breaches of charitable trusts. The reports of these commissions over a period of years "revealed a large number of abuses and led to a considerable increase in the number of charity causes before the Court of Chancery."[50] However, the commissions had no enforcement powers, and could only conduct inquiries and issue reports, which frequently were not acted upon by the Attorney General. According to Jones this proved ineffective since "many dishonest trustees withstood with equanimity the glare of unfavorable publicity."[51]

Up to this time the primary concern of charity reformers had been to secure the preservation and proper administration of charitable trusts. Then a second problem began to emerge as a serious obstacle to reform – the need to break away from the strict rules of the centuries-old *cy pres* doctrine governing the changing of the objects of outmoded charitable trusts. In general, under the *cy pres* doctrine the charitable purpose to which a trust was dedicated could be changed only when the purposes could not be attained; and even then the new charitable purposes had to be as near as possible to those specified by the founder. In addition, such a change could be achieved only by a proceeding in Chancery which was so expensive as to be impractical for many charitable trusts.

By a series of statutes enacted in 1853, 1855, and 1860, Parliament undertook to deal with these problems by creating a three-man administrative body, called the Charity Commissioners, which had the following general functions:[52]

> *Advisory:* giving advice upon the application of the trustees or others concerned in the administration of a trust;
>
> *Administrative:* giving directions upon the application of trustees or others concerned in the administration of trusts; controlling dealings with the property of trusts; controlling legal proceedings by trustees; settling the compromise of claims by, or against, trustees (which are final and a bar to all subsequent actions, suits, claims or demands);
>
> *Supervisory:* investigating the administration of charities including their accounts and taking any further action which may consequently appear to be proper;
>
> *Quasi-judicial:* appointing or removing trustees or removing officers; establishing and making schemes within the limits of the *cy pres* doctrine, subject to appeal to the Chancery Division of the High Court.

In its 1952 report, the Nathan Committee stated that the work of the Charity Commissioners had been "of great benefit to charitable trusts and therefore to the country."[53] The committee recommended that this basic system be retained and strengthened.

Steps in this direction were taken in the Charities Act of 1960.[54] For the first time, the Charity Commissioners were placed under the jurisdiction of the Home Secretary, thereby gaining direct access to an important department of state which could represent the commissioners' views in Parliament. A system of public registration of charities was enacted, and the commissioners were authorized to institute inquiries in regard to charities under their jurisdiction, and to take appropriate remedial action, such as removing the trustees and vesting charitable property in the Official Custodian for safekeeping. In addition, the long sought after relaxation of the *cy pres* doctrine was achieved. Moreover, Charity Commissioners were authorized to devise "schemes" for the reorganization of outmoded trusts if requested to do so by the trustees or the courts.

The History of the Tax Exemption of Charities in England

Property Taxation

For many centuries the question of exempting the property owned by charity from local taxation remained unresolved by any body having national jurisdiction. The early judicial decisions, following custom in many parts of the country, inclined toward exemption of charitable property.[55] However, in 1866 the legal theory supporting these decisions was overruled by the House of Lords.[56] Thereafter, local authorities became increasingly inclined to look to charities for the payment of local rates on their property. There was no uniformity, however, as to the valuation of such property, and in many places it was assessed at a nominal value.

In 1948 the Local Government Act withdrew valuation powers from local authorities and vested them in the Board of Inland Revenue. As a result, many charities faced the prospect of higher tax rates. In 1955 Parliament granted charities temporary relief from the abrupt increase in rates which would have resulted from full and uniform valuation of their property. Four years later, a study commission recommended that charities be granted uniform mandatory relief at the rate of 50 percent.[57] The recommendations of this commission were substantially adopted in the Rating and Valuation Act of 1961 and reenacted in the General Rate Act of 1967. At the present time, where property is occupied by a charity and "wholly or mainly used for charitable purposes," the tax rates are reduced by one half. Moreover, the statute grants discretionary power to the rating authorities to further reduce or completely omit the payment of taxes on charitable property.[58]

Income Tax

Charitable organizations have been exempt from income tax in England since the enactment of the first Income Tax Act in 1842. It was decided in the *Pemsel* case[59] that there is in English law only one definition of a charity. Accordingly, if an organization falls within the legal definition of charity as defined by the courts in cases regarding charitable trusts, which is discussed above, it is also a charity for purposes of tax exemption.[60]

The position of charities from the standpoint of tax exemption was discussed in Chapter 7 of the Final Report of the Royal Commission on the Taxation of Profits and Income (1955). The commission took a restrictive point of view with respect to the question of exemption:

> In our view what is amiss in the present system is not the idea of giving income tax relief in respect of charity but the undue width of the range of what ranks as a charity for this purpose. It is the vagueness of definition or, more precisely, the absence of definition which provokes criticism: for it enables the very sub-

> stantial benefits of exemption to be claimed by activities which, in extreme cases, have no real connection with the idea of charity at all. It is here that we think that some action is called for.[61]

The commission recommended that the definition of charity for tax purposes be made more limited and more precise. It argued that the new definition be established on these lines:

> [T]he relief of poverty, or prevention or relief of distress, the advancement of education, learning and research, the advancement of religion.[62]

The commission acknowledged that if the suggested definition were adopted, "exemption would be denied to a number of praiseworthy activities which at present enjoy it." The new definition would also "make the range of favoured activity less flexible than it has been hitherto and so, perhaps, less responsive to the new growths of a changing society." While recognizing these considerations, the commission concluded that they were not "strong enough to require the maintenance of the present situation."[63]

An even stricter view was expressed by two dissenting members of the commission who believed that total exemption from tax could be justified only for charities performing functions that were recognized as responsibilities of the State. The dissenters also objected to the fact that whereas direct government grants are reviewed from time to time with a view to adjusting them, if necessary, to the economic exigencies of the moment, no similar review was made with respect to the tax exemption of charities.[64]

Despite the commission's report, Parliament has not adopted a new comprehensive definition of charity for income tax purposes.[65]

The Legal History of Charities in America

The Colonial Experience

The colonists who settled America brought with them the English legal and social tradition of an active private philanthropy. This tradition, coupled with the needs of the colonists and the encouragement of charitable activity by the colonial churches, created an environment favorable to the formation of charitable organizations designed to meet the needs for social services within the primitive frontier society.[66]

Both public and private agencies, often working together, established schools and assisted the poor.[67] Governmental interference in private charity was minimal.[68]

> [The colonists] did not debate the question of public versus private responsibility. . . . In the work of establishing cherished social institutions on American soil, public and private philanthropy were so completely intertwined as to become almost indistinguishable. The law itself reflected a pragmatic approach to the solving of social problems through philanthropy. Colonial assemblies went out of their way to remove obstacles in the way of charities. The courts, valuing social betterment above legal technicalities, asserted a permissive charity doctrine that supported donors' benevolent intentions, even when the formulation of their plans was clearly imperfect.[69]

The incidence of poverty in colonial America was not as great as in England and, to the extent that poverty did exist, churches and local governments assumed the burden of alleviating it.[70] In this setting, private donors turned to education as their principal charitable activity. It has been estimated that 80 percent of the private funds devoted to charity before the Revolution (not including gifts of an educational nature made through religious channels) were probably applied to educational purposes.[71] After the Revolution, this trend was accelerated.

The Development of Vehicles for Conducting Charitable Activities

At the time of the American Revolution and for many years thereafter, state governments played the principal role in formulating governmental policy with respect to charity. Operating charitable institutions, such as schools, hospitals, and religious groups, were usually incorporated by special act of the legislature,[72] and several states adopted other forms of legislation to protect and support their charities.[73] However, the policy of state governments toward charitable organizations was not uniformly favorable. Fear of a rise in the power of the church through the accumulation of property led some states to impose restrictions on property held by religious corporations.[74] For example, in Virginia and Maryland, acts were passed to restrict the capacity of churches to acquire property and to administer relief to the poor.[75]

The American Revolution also brought a wave of nationalist and anti-British sentiment.[76] This resulted in the adoption of constitutional and statutory provisions intended to "cleanse" the inherited system of English jurisprudence of features that were deemed incompatible with the new republic.[77] Some states repealed all English statutes en masse, including the 1601 Statute of Charitable Uses. Some jurisdictions also rejected the *cy pres* doctrine in the mistaken belief that it was exercisable only by the prerogative power of the king.[78]

This cleansing of British law led ultimately to the rejection of charitable trusts by a number of states, based upon the reasoning of the U.S. Supreme Court in *Trustees of Philadelphia Baptist Association v. Hart's Executors.*[79] In that case a testamentary charitable trust for the benefit of an unincorporated religious association was held invalid because Virginia, the testator's state of domicile, had, prior to the testator's death, repealed the Statute of Charitable Uses along with other English statutes. According to the Supreme Court, judicial power to enforce charitable trusts stemmed only from the Statute, and its repeal in Virginia made the trust unenforceable. This conclusion, while based on dicta in English cases, was historically incorrect because the Statute merely provided a new remedy for enforcing charitable trusts and did not supersede or eliminate the jurisdiction that the Chancellor had exercised over such trusts prior to the enactment of the Statute.

The *Philadelphia Baptist Association* case was overruled 25 years later in *Vidal v. Girard's Executors,*[80] when historical records not previously available proved that charitable trusts had been enforced in England before the adoption of the Statute of Charitable Uses. However, the error had become so firmly entrenched in some states that despite the *Girard* case, they continued to follow it for another half century.[81] Moreover, during this period, New York, Michigan, Minnesota, and Wisconsin enacted codifications of their trust laws under which charitable trusts were held by the courts to be invalid.[82] Because of these legal obstacles, the trust device was not available as an instrument for accomplishing charitable purposes in a number of states until around the beginning of the twentieth century. Today all states recognize the validity of charitable trusts.[83]

In view of the rejection of charitable trusts in a number of important states, reliance was placed upon the charitable corporation as the primary legal mechanism for carrying on charitable activities in America. As noted above, before the Revolution corporations were created by charters issued by the Crown or the Royal Governor, or, in some instances, colonial assemblies. Religious corporations constituted the most numerous group of private corporations in the colonies, and many of the charitable and educational institutions were also chartered under religious auspices.[84] Following the Revolution, some states enacted statutes authorizing general incorporation for charitable purposes.[85] By the middle of the nineteenth century, general corporation laws were common throughout the U.S., and by the beginning of the twentieth century charitable corporations were rarely incorporated by special act of the legislature.[86]

In view of the heavy reliance upon charitable corporations as the major instrument for conducting charitable activities in America, it is interesting to note the following observation in a study, *The Law and the Lore of Endowment Funds*, published in 1969:

> The law relating to charitable corporations in general, and particularly to the administration of endowment funds, remains throughout the nation both 'rudimentary and vague.' '[T]he great and rapid increase in the number and aggregate wealth of charitable corporations has taken the law by surprise,' and the courts and commentators are still groping for a solution.[87]

Part of the reason for this uncertain state of the law relating to charitable corporations is historical. As previously discussed, much of the American law of charity is derived from the English common law. Under English court decisions, charitable corporations were traditionally viewed in legal theory as founded for the administration of charitable trusts.[88] Problems naturally arose when this theory was sought to be applied in American jurisdictions that did not enforce charitable trusts.

Moreover, even in states where charitable trusts were enforced, the legal rules applicable to such trusts did not always produce the desired result when applied to charitable corporations. *The Law and the Lore of Endowment Funds* summarizes the unique legal nature of a charitable corporation:

> A charitable corporation is obviously similar to other corporations. It also shares certain characteristics with charitable trusts, and the agreements it reaches with the donors of its endowment funds are in the nature of contracts. The separate principles evolved by the law in relation to corporations, trusts and contracts are all quite well developed, and the courts and commentators have naturally drawn upon those principles in attempting to determine what standards should govern the administration of endowment funds. Unfortunately those principles are not always complementary; at times they are in direct conflict. The result has been 'an uneasy mixture of trust, contract and corporation language, the force of which may be difficult to predict in a particular situation. . . .'
>
> [T]he law governing charitable corporations is not merely a branch of trust law, or corporate law, or contract law, but instead is *sui generis*, drawing to some extent on all three of the older disciplines. Where the issue is the ownership of property, courts in all states strain to uphold the claim of the charity involved, rather than see the property lost to private hands. In other cases not involving administration, no general pattern is discernible. But where the issue involves the investment of funds, accounting for their use or other aspects of administration or housekeeping, the courts show a marked tendency to apply corporate principles rather than trust principles, in order to accord charitable corporations a maximum degree of flexibility in their operations. . . .[89]

Within the past five years state legislatures have begun to take note of the need for clarification of the law relating to charitable corporations. In New York a major recodification became effective in 1970 under the title of the New York Not-for-Profit Corporation Law. In 1973 Pennsylvania enacted an extensively revised Nonprofit Corporation Law. The National Conference of Commissioners on Uniform State Laws approved in 1972 the Uniform Management of Institutional Funds Act, which is intended to clarify the law relating to the management of charitable funds and to permit greater flexibility in the selection of investments, the delegation of investment responsibility, and the allocation of capital gains between principal and income. This act has been enacted into law in a number of states.[90]

The Tradition of Exempting Charitable Organizations From Tax Under State and Local Law

From the early days of colonial America, religious and educational institutions have been accorded exemption from property taxation, and, to a lesser extent, from other forms of taxation. Property held by colonial churches that were "established" churches, supported by public taxation, received the same exemption as other public property.[91] Moreover, a number of colonies granted the same exemption, as well as support from public revenues, to dissenting churches.[92] Following the Revolution and the separation of church and state, the practice of exempting church property was continued, the exemption being "so entirely in accordance with public sentiment, that it universally prevailed."[93]

The colonies accorded similar exemption to educational institutions:

> This custom was almost universal among the colonies, and even extended so far as to exempt in several instances the property of the members of the college or university. . . . The principle of exemption of educational institutions from taxation has been so grounded in the nature of our Government as to represent a practically irrevocable law.[94]

As noted above, in colonial America churches and towns bore the primary responsibility for relief of the poor, a function in which the states increasingly shared over time. In the nineteenth century, secular charitable institutions assumed a more significant role in the conduct of charitable work. This development was accompanied by the enactment of legislation exempting the property of such institutions from state and local taxation. The process by which this occurred has been described as follows:

> But insofar as the state permitted private institutions to take over the work of charity, the latter were *pro tanto* relieving the State of a burden which it had avowedly undertaken to bear. Private institutions were thus performing a public function. The *quid pro quo* which the private institutions received was immunity from taxation. But it must be observed that what is done here is to state the terms of a bargain which we have not before us. It is not to be supposed that the bargain was openly made and publicly declared. There is no direct evidence that such a bargain was ever made. The process of exempting these private institutions developed imperceptibly, subtly. It was a spontaneous process, leaving no trace of its origin or immediate development.[95]

Today, every state in the union has some form of property tax exemption in favor of charitable organizations.[96] Many states also exempt charitable organizations from inheritance,[97] income,[98] and sales taxes.[99] However, there is little uniformity in the various exemption provisions. For example, exemption of charitable property from tax may extend only to real property,[100] only to personal property,[101] or to both real and personal property.[102] The availability of an exemption in each case is determined by applying to the facts the particular statute under consideration.

Also, state taxing statutes have historically differed in the language used to describe the purposes of institutions eligible for exemption. For example, the New York statute lists more than 20 different specific charitable purposes for which organizations may be organized and qualify for property tax exemption.[103] The Pennsylvania statute, by comparison, exempts only religious, charitable, and educational institutions.[104]

Additionally, different tax statutes within the same state are often inconsistent. In New York, for example, exemption from income tax is accorded to "[a] trust . . . which by reason of its purposes or activities is exempt from federal income tax."[105] However, New York's real property tax law[106] sets forth its own list of exempt purposes, and organizations characterized as charitable or educational for federal tax purposes may be subjected to real property tax for failing to fall within an exempt state classification.[107]

There appears to be little likelihood that uniform criteria for exemption at the state and local level will be achieved in the foreseeable future. In some states the trend actually seems to be in the opposite direction. In 1971, for example, the New York legislature amended its real property tax law to authorize municipal corporations to tax formerly exempt real property owned by institutions which are

> . . . [o]rganized or conducted exclusively for the moral or mental improvement of men and women or for bible, tract, benevolent, missionary, infirmary, public playground, scientific, literary, bar association, medical society, library, patriotic or historical purposes, [or] for the enforcement of laws relating to children or animals. . . .[108]

At the same time, the legislature mandated continued exemption for property of institutions "organized or conducted exclusively for religious, charitable, hospital, educational or cemetery purposes."[109] As a result of this amendment, property held by a nonprofit organization in one part of New York State might be exempt from tax while similar property used for identical purposes by the same organization in another part of the state might be subject to tax.

The History of the Exemption of Charities from Federal Taxation

Prior to the end of the nineteenth century, federal revenues were derived primarily from import duties and excise taxes which did not affect charitable organizations. With the adoption of the first federal income tax law in 1894,[110] imposing a tax on the income and profits of corporations generally, the tradition of exempting charity from tax, as developed in England and incorporated into American state and local law, was expressed on a national level. Although the legislative history is silent on the matter, it seems likely that the federal draftsmen reviewed the state exemption statutes and noted their lack of uniformity and also the considerable degree of specificity with which they were written. Presumably wishing to avoid a similar tangle at the national level, the federal draftsmen framed the exemption in broad and simple terms as follows:

> That nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious or educational purposes, . . . nor to the stocks, shares, funds, or securities held by any fiduciary or trustee for charitable, religious, or educational purposes. . . .[111]

An exemption in favor of such organizations has appeared in every subsequent federal income tax law.

The 1894 income tax was declared unconstitutional a year later,[112] but the substance of the 1894 exemption provision was carried over to the Corporation Excise Tax of 1909 which provided that the tax should not apply "to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."[113]

The constitutional obstacle to a federal income tax was removed in 1913 by the adoption of the Sixteenth Amendment to the U.S. Constitution. Enacted in that same year, the first income tax law under the Sixteenth Amendment[114] contained an exemption in favor of charitable, religious, educational, and scientific organizations. The exemption for these organizations was repeated in the Income Tax Acts of 1916[115] and 1918,[116] and has continued to the present. The phrase "or the prevention of cruelty to children or animals" and the word "literary" were added to the list of exempt purposes in 1918[117] and 1921,[118] respectively, and the phrase "testing for public safety" was added in 1954.[119] Limitations regarding legislative and political activities were added in 1934[120] and 1954.[121]

The basic income tax exemption provisions have been supplemented by other federal tax provisions favorable to charitable organizations. In 1898, a federal tax was imposed upon legacies,[122] without exemption for legacies to charitable, religious, and educational institutions. Three years later, in 1901, an exemption was provided for subsequent legacies to charitable, religious, and educational organizations and for all prior legacies of that type with respect to which tax had not yet been paid.[123] In 1902, remedial legislation was passed authorizing a refund of all taxes previously paid on such legacies.[124]

In 1916, a federal estate tax was adopted.[125] In contrast to the 1898 legacy tax, which applied separately to each legacy, the estate tax was imposed on the entire estate at progressive rates. No deduction was originally allowed for charitable dispositions, a treatment that paralleled the income tax law in effect at the time, which similarly allowed no deduction for charitable contributions. These omissions were remedied when Congress in 1917 provided an income tax deduction for charitable contributions of individuals (limited to 15 percent of the donor's taxable income)[126] and in 1919 authorized an estate tax deduction for bequests to charitable organizations.[127]

A gift tax deduction in favor of gifts to charity was included in the federal gift tax law of 1926.[128] An income tax deduction for charitable contributions by corporations was enacted in 1935.[129]

Beginning in 1950 the development of federal tax policy regarding charitable organizations entered a new phase. For the first time, statutory rules were enacted to deal with business activities of various charities and with certain areas of abuse, including self-dealing, imprudent investments, and unreasonable accumulations of income. Further steps in the direction of charities reform were taken by Congress in the Tax Reform Act of 1969, which established detailed statutory rules to govern the conduct of private foundations in the areas of self-dealing,[130] excess business holdings,[131] timely distribution of income,[132] investment of assets,[133] and expenditures of funds for certain prohibited purposes.[134] The 1969 Act also imposed an excise tax on each private foundation in an amount equal to 4 percent of the foundation's net investment income.[135]

Aside from the 4 percent excise tax and the other restrictions imposed by the 1969 Act, the basic policy of U.S. tax legislation has been to encourage charitable organizations through tax exemption and deductibility of contributions. This U.S. policy may be contrasted with the tax treatment of charities in England, as discussed earlier, where considerably less encouragement has been given.

II

RULES APPLYING TO ALL 501 (c) (3) ORGANIZATIONS

This Chapter deals with the formation of 501 (c) (3) organizations, their day-to-day operation, and their participation in the political process. The rules discussed herein apply to all 501 (c) (3) organizations regardless of the purpose for which the entity is organized and operated.

Generally, the rules in all three areas are not precise, and in those areas where the IRS has for administrative reasons tried to create specificity, the courts have been inclined to be lenient. Nevertheless, these rules are important because a violation of them may mean loss of exemption. For this reason 501 (c) (3) organizations constantly evaluate their conduct in relation to these rules.

Requirements Pertaining to the Founding Document and Form of Organization

Section 501 (c) (3) applies to "Corporations, and any community chest, fund, or foundation. . . ." The IRS regards the phrase "corporation, community chest, fund or foundation, as encompassing, with one exception, any organizational format (including a trust), so long as the organization's founding document provides for officers empowered to act for the organization.[136] The one exception is partnerships, which are not recognized as 501 (c) (3) organizations.[137]

The regulations imply that an organization must have a founding charter, referred to in the regulations as the "articles of organization." This term is defined as follows: "For purposes of this section, the term 'articles of organization' or 'articles' includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created."[138] The practice of the IRS is to read this language narrowly. The *Exempt Organizations Handbook* states:

> . . . the organizational test cannot be met by reference to any document that is not the creating document. In the case of a corporation, the bylaws cannot remedy a defect in the corporate charter. A charter can be amended only in accordance with state law, which generally requires filing of the amendments with the chartering authority. In the case of a trust, operating rules cannot substitute for the trust indenture. In the case of an unincorporated association, the test must be met by the basic creating document and the amendments thereto, whatever that instrument may be called. Subsidiary documents that are not amendments to the creating document may not be relied on.[139]

Courts have on occasion rejected the strict IRS position stated above and have held that the proven intent of the founders of the organizatiion may substitute for a written founding document. Bylaws have been accepted in place of articles of incorporation. Even where there is no written charter, the actions of the founders of the organization have substituted for a missing charter when the actions of the founders clearly express charitable intent.[140]

The regulations also provide that the founding document will be acceptable only if it limits the purposes of the organization "to one or more exempt purposes."[141] In reference to this requirement, the regulations state that "In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in 501 (c) (3)."[142]

The regulations provide examples of charters that are acceptable:

> Therefore, an organization which, by the terms of its articles, is formed 'for literary and scientific purposes within the meaning of section 501 (c) (3) of the Code' shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organizational test. Similarly, articles stating that the organization is created solely 'to receive contributions and pay them over to organizations which are described in section 501 (c) (3) and exempt from taxation under section 501 (a)' are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set forth the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of operation of such school. In addition, if the articles state that the organization is formed for 'charitable purposes,' such articles ordinarily shall be sufficient for purposes of the organizational test. . . .[143]

Thus, a charter that merely explains its purposes by tracking the language of the statute is acceptably limited.[144]

In regard to the founding document, the regulations also provide that "In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in Section 501 (c) (3)."[145]

The IRS has rejected charters it considered overly broad. However, in situations where all of the other requirements for exemption are met, the courts have been reluctant to regard this factor as determinative.[146]

The regulations also provide that the founding document of an organization must not ". . . expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501 (c) (3)."[147]

The meaning of this requirement is clarified with an example: "Thus, an organization that is empowered by its articles 'to engage in a manufacturing business,' or 'to engage in the operation of a social club' does not meet the organizational test regardless of the fact that its articles may state that such organization is created 'for charitable purposes within the meaning of section 501 (c) (3) of the Code'."[148]

This requirement has not been strictly enforced by the courts. Recognizing that it may be impossible to tell from the wording of a charter whether an authorized activity is "insubstantial,"[149] the courts have addressed the issue of whether nonexempt activities actually engaged in by the organization constitute a substantial part of its overall activities.[150]

Finally, the regulations require that the founding document provide for the distribution of assets in the event of dissolution of the organization:

> An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.[151]

Even if the charter does not provide for the disposition of assets upon termination, the charter is not defective if under state law the assets must be distributed "for one or more exempt purposes." In many states the applicable statute specifically provides for a proper distribution.[152] However, for administrative reasons the IRS prefers a charter provision regardless of state law, and the absence of such a provision may delay the granting of an organization's application for tax exemption.[153] Where reliance is placed on state law, the IRS takes the position that the state law must be unambiguous, and that the burden of justifying such reliance rests on the organization.[154]

This requirement of the regulations has met with skepticism in the courts.[155] Except where the activities of the organization as a whole indicate a nonexempt purpose would be served by the distribution of assets on termination,[156] the IRS position has been rejected. The requirement that the organization clearly demonstrate that state law provides for a charitable distribution in the event of dissolution has also been rejected.[157] However, when the charter specifically provides for a private benefit on dissolution, the courts would presumably deny the exemption.[158]

These requirements concerning the format and founding charter of a 501 (c) (3) organization affect the organization during its formation. Generally, they comprise what is referred to in the regulations as the "organizational test."

Because of reluctance to disqualify an organization for a mere defect in form, the courts have been willing to waive strict compliance with the organizational test in cases where the organization otherwise merited exemption. Nevertheless, because the IRS will not approve an exemption application under section 501 (c) (3) unless these requirements are satisfied, it seems likely that all 501 (c) (3) organizations created since promulgation of the regulations in 1959 are governed by charters that reflect the IRS position concerning format and founding document.

Requirements Affecting Day-to-Day Operations of 501 (c) (3) Organizations

The regulations provide that a 501 (c) (3) organization must be primarily engaged in activities that further its exempt purposes:

> An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501 (c) (3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[159]

This regulation is less stringent than section 501 (c) (3), which states that an organization must be "operated exclusively" for an exempt purpose.[160]

When the regulation was promulgated, commentators welcomed the fact that the IRS had not applied the "exclusively operated" language of section 501 (c) (3) literally, but they pointed out the uncertainty arising from the phrase "insubstantial."[161]

At present, the meaning of "insubstantial" has not been clarified. The IRS has acknowledged using a 5 percent test in determining whether an organization is engaged in "substantial" political activity.[162] However, for purposes of the regulation quoted above, the IRS does not appear to apply a specific percentage test but instead approaches each case on an individual basis.[163]

A second important requirement is that the activities of a 501 (c) (3) organization must serve a "public rather than a private interest." The regulations provide: "An organization is not organized or operated exclusively for one or more [exempt] . . . purposes unless it serves a public rather than a private interest."[164]

This is one of the most important substantive requirements of section 501 (c) (3). The regulations state that in order to meet this requirement:

> . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.[165]

Moreover, the regulations provide explicitly that "An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."[166]

Thus, in defining a private interest, the IRS has had to define the term "private shareholder or individual," define what constitutes a "benefit," and determine what kinds of organizations by their very nature provide private benefits.

The IRS takes the position that a private shareholder or individual includes any person "having a personal or private interest in the activities of the organization."[167] In practical effect, the rule against serving a private interest regulates the dealings of 501 (c) (3) organizations with all persons.

The IRS and the courts have taken a very broad position in regard to what constitutes a "benefit." It is clear that "benefit" is not limited to cash distributions.[168] Any type of dealing which is not at arm's length can be held to result in a prohibited private benefit.[169] Even a benefit as intangible as publicity has been called into question.[170]

The prohibition against private benefit is not violated by the payment of reasonable compensation for services rendered to a 501 (c) (3) organization to enable it to carry out its exempt purpose.[171] In practice, payments of compensation will be questioned only when they are "excessive" in terms of the practice of other comparable organizations.[172] Where it is difficult to make a reasonable guess as to the practice of other comparable organizations, reference will be made to organizations that operate on a profit-making basis. Thus, where a salary is reasonable as a deductible business expense, it will generally be considered reasonable for exemption purposes.[173]

It is of course clear that in appropriate circumstances a 501 (c) (3) organization can give money, goods, or services to individuals without losing its exempt status. Many forms of charity involve aid to individuals. However, an organization that provides benefits to its members "in the event of death, illness, or disability, without regard to financial distress" is regarded as a "mutual benefit association, not a charity."[174] On the other hand, where the mutual benefits of a charitable organization are only a small part of the organization's activities, they will not result in loss of exemption.[175]

Even though all of the formal requirements of the regulations are met, exemption under section 501 (c) (3) will be denied if an organization is operated as an adjunct of the private business or professional practice of those who control it. An example is a private hospital which limits its services to the paying patients of the members of its medical staff, who also control it.[176]

Organizations involved in social activities are likely to be closely scrutinized to determine if they are being operated for the private benefit of their members. The IRS concern about social activities is reflected in the regulations, which state that exemption will not be granted if the organization's charter empowers it "to engage in the operation of a social club."[177] However, courts have taken a liberal attitude with respect to incidental social activities since "[p]ractically all religious and educational associations and some charitable organizations make use of social or athletic features."[178] Moreover, a large organization can have more social activities than a small one, since incidental nonexempt functions are measured against the background of the organization's total activities.[179]

Other aspects of the question of whether an organization serves a public rather than a private interest are discussed further in the sections of this report dealing with charitable, religious, educational, and scientific organizations.

Requirements Pertaining to Legislative and Political Activities of 501 (c) (3) Organizations

A 501 (c) (3) organization must be organized and operated in such a way that it conforms to a set of rules respecting legislative and political activity. The limitations upon the legislative activities of publicly supported 501 (c) (3) organizations are currently the subject of congressional attention, and substantial changes concerning the rules in this area may be forthcoming in the future.[180] Currently, the regulations label an organization engaged in prohibited legislative or political activity an "action organization," which is not exempt from taxation under section 501 (c) (3).[181]

Engaging in any of the three following activities can lead to classification as an action organization: (1) attempting to influence legislation, (2) participating in a political campaign, and (3) having a primary objective that may only be attained by legislation or a defeat of proposed legislation.

The ban on influencing legislation is contained in section 501 (c) (3), which provides that an exempt organization is one, ". . . no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation." The meaning of "substantial" has not been explicitly defined even though courts have long wrestled with the issue,[182] but the relevant factors to be considered have been identified.

Determining whether an organization has violated this prohibition requires a decision as to what activities are included within the category of influencing legislation; it requires a decision as to the relevant time period over which such activity is to be measured; and, finally, it requires a decision as to the standard against which the substantiality of such activity is to be measured.

The regulations provide that an organization will be regarded as attempting to influence legislation if the organization

> (a) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or
>
> (b) Advocates the adoption or rejection of legislation.
>
> The term "legislation," as used in this subdivision, includes action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment or similar procedure.[183]

The IRS has interpreted this to include contacting members of the exempt organization and urging them to contact the legislators; urging action on legislation in the organization's official publications, pamphlets, or newsletters; contacts with legislators by officers and members of the exempt organization; individual correspondence; press releases, newspaper and magazine advertisements; employment of public relations services; and the employment of a professional legislative representative.[184] Furthermore, in determining whether an organization is attempting to influence legislation, the IRS will examine ". . . all of [the organization's] literature, meetings, letters, communications. . . . The entire organizational structure [will] be dissected. A careful judgment [will] be made of the nuances contained in the various communications."[185]

The IRS recognizes an exception for one type of legislative activity. If the exempt organization

> . . . did not initiate any action with respect to pending legislation, but merely responded to an official request from a [legislative body] . . . . [i]t cannot, . . . be described as attempting to influence legislation by contacting members of a legislative body to propose, support, or oppose legislation or by advocating the adoption or rejection of legislation. The attempts to influence legislation as described in the regulations imply an affirmative act and require something more than a mere passive response to a Committee invitation.[186]

In regard to the time period over which legislative activity is measured, the courts have adopted a year-by-year approach, delineated by the beginning and end of the organization's taxable year.[187] However, it has been stated that the IRS prefers ". . . a flexible open-ended standard for determining the periods during which legislative activities of an organization should be measured."[188]

The final question involved in determining the substantiality of legislative activity is the standard against which such activity is to be measured. There have been indications that the IRS questions legislative activity where it constitutes more than 5 percent of an organization's total activities.[189] However, the *Exempt Organizations Handbook* states that "[t]here is no simple rule as to what amount of activities is substantial."[190] The courts have reached decisions in particular cases through a balancing approach in which the issue is resolved by considering what "portion of the total activity" is involved with influencing legislation; what the activities were "intended" to promote; and what the nature of those activities are.[191]

The question of legislative activity is complicated by the fact that under the definitions of "educational" and "charitable," the regulations sanction certain types of activity that might have an impact upon the political process. "Educational" is defined to include "The instruction of the public on subjects useful to the individual and beneficial to the community."[192] The examples given under "educational activity" include "An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television."[193]

Under the definition of "charitable" the regulations state:

> The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501 (c) (3) so long as it is not an "action" organization. . . .[194]

This problem is presented by the case of an organization whose primary purpose is to improve government honesty or efficiency. This is a recognized charitable purpose, and also a recognized educational purpose where it involves "educating the public." In such a case, the IRS determines first whether the organization's primary purpose in advocating civic changes is to further the charitable and educational purposes of the organization; and second, whether the means of advocacy used to achieve those purposes rise to the level of activities that are prohibited under the "action organization" provisions.

Thus, where an organization's purpose is to elevate "the standards of ethics and morality in the conduct of campaigns for political office," and where it proposes a "code for fair campaign practices" which it recommends be followed, but which it does not urge be enacted into law, the organization can qualify as a 501 (c) (3) organization because its activities (1) are directly related to its charitable purpose (creating good government) and (2) do not rise to the level of "contacts" with legislators.[195]

The statute also prohibits participation in political campaigns. Unlike the limitation on legislative activity, which applies only where such activity is substantial, the statutory ban on political activity is unqualified. Section 501 (c) (3) exempts only organizations ". . . which [do] not participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office."

The regulations provide "An organization is an action organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office."[196]

The IRS interprets the phrase "candidate for public office" broadly to include ". . . an individual who offers himself, or is proposed by others, as a contestant for an elective public office."[197] Moreover, if an organization supports or opposes candidates, the fact that it does so on a nonpartisan basis does not take it out of the prohibition. As the *Exempt Organizations Handbook* states, "[t]he first point to be noted is that this is an absolute prohibition."[198]

Since the prohibition is against both "direct and indirect" participation in political campaigns, the prohibition has caused problems for educational institutions because of the possibility that campus political activities of their students, involving use of the institution's facilities on behalf of candidates, might be viewed as indirect activity by the institution itself.[199] However, it should be noted that the prohibition is not against participation or intervention in political campaigns *per se*, but against participation "on behalf of or in opposition to" a candidate. Thus, for example, where a political science course requires students to participate in a political campaign for the purpose of furthering their education, the prohibition is not violated.[200]

The final limitation concerning political activity is stated in the regulations as follows:

> An organization is an "action" organization if it has the following two characteristics: (a) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding circumstances, including the articles and all activities of the organization, are to be considered.[201]

There is very little published authority as to the meaning of this regulation. It was apparently at issue when the IRS revoked the exempt status of the Fellowship of Reconciliation, "a movement of Christian protest against war, and of faith in a better way than violence for the solution of all conflicts."[202] Although the Service delineated two alternative reasons for withdrawing the organization's exemption, the primary ground was as follows: "It is our position that a purpose of 'antimilitarism, peace, and international reconciliation,' is a political purpose and not within the orbit of section 501 (c) (3). . . . Resolving international controversies is a political purpose, not a charitable religious purpose."[203] Within a few months, however, the IRS reversed itself and issued a second ruling declaring the organization exempt.[204]

The courts have generally followed a policy of looking "to the behavior of an organization, rather than its aims, once it becomes clear that the organization, in general terms, is within the class whose purposes might be characterized as charitable."[205] A court will not deny charitable status "[m]erely because some ultimate effect . . . [may be] realized in legislation . . . ," since charitable work results in "bringing to the attention of the individual citizens the need for many things, some of which could be remedied by local means and others which perhaps would require legislation by the State. The information acquired by the public from [such charitable] work would normally tend to have some effect in the actions of State legislators, elected by the people, to enact . . . legislation."[206]

III

THE SEARCH FOR A MODERN DEFINITION OF CHARITY UNDER SECTION 501 (c) (3)

In order to qualify for exemption under section 501 (c) (3), an organization must be formed and conducted for one or more of the purposes set forth in that section: charitable, religious, educational, scientific, literary, testing for public safety, prevention of cruelty to children or animals.

All of the foregoing purposes (except testing for public safety) are also enumerated in the sections of the Internal Revenue Code that permit income, estate, and gift tax deductions for so-called "charitable" contributions. (These are sections 170 (c) (2), 2055 (a) (2), 2106 (a) (2) (A) (ii), and 2522 (a) (2).)

Each of these exempt purposes is, in a sense, a distinct concept which is delineated by criteria that differ from those pertaining to the other purposes enumerated in section 501 (c) (3). However, there is also an overlap between these enumerated purposes, as indicated by the fact that the regulations provide that the term "charitable" includes the advancement of religion, education, or science. A common thread which runs through much of section 501 (c) (3) is derived from the concept of charity as developed by judicial decisions over several centuries and, more recently, by IRS interpretations of these decisions in the context of the federal tax laws.

This part of the report will examine the legal criteria that determine whether an organization is "charitable" for purposes of section 501 (c) (3). We first consider the difficulty encountered by judges, text writers, and the IRS in formulating a satisfactory legal definition of the term "charitable." We then discuss the nature of charity as an evolving concept which is shaped by the needs and values of contemporary society. And, lastly, we undertake to identify the principles that appear to guide the evolution of charity under section 501 (c) (3). In this discussion attention will be focused upon the revenue rulings published by the IRS under section 501 (c) (3) since the meaning of "charity" for this purpose is greatly influenced by these rulings. Court decisions and statutes which shed light upon the evolving legal concept of charity will of course also be discussed.

Attempts to Define "Charity"

There is no statutory definition of the term "charitable" for purposes of section 501 (c) (3). However, the regulations state that

> The term "charitable" is used in section 501 (c) (3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501 (c) (3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions.[207]

As noted in the historical section of this report, certain types of purposes have for centuries been regarded as "charitable." These traditionally charitable purposes are reflected in the following definition of "charity" which was formulated by Justice Gray in 1867:

> A charity, in the legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, for the benefit of an indefinite number of persons, either by bringing their minds and hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.[208]

This statement is a comprehensive summary of the scope of charity at the time it was written. However, as a definition of charity it is not complete because it fails to recognize that additional charitable purposes will emerge as conditions in society change. In 1891 Lord Macnaghten appeared to acknowledge this open-ended aspect of charity by defining it as follows in his famous opinion in the *Pemsel* case:

> "Charity" in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads. . . . The trusts last referred to are not the less charitable in the eye of the law, because incidentally they benefit the rich as well as the poor, as indeed, every charity that deserves the name must do either directly or indirectly.[209]

Under Lord Macnaghten's definition, newly perceived purposes that are "beneficial to the community" can presumably qualify as charitable even though they are not included within any of the traditional categories.

The Treasury Department regulations which define "charitable" for purposes of section 501 (c) (3) follow an approach going beyond Justice Gray's and close to that of Lord Macnaghten. In addition to stating that the term "charitable" is used in section 501 (c) (3) in its "generally accepted legal sense," the regulations go on to provide that the term "charitable" includes

> Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.[210]

It will be noted that the regulations include all of the traditional categories of charity referred to by Justice Gray and Lord Macnaghten, and in addition they include several specifically enumerated purposes more recently recognized. The specific mention of these latter purposes in the regulations is of course evidence of the fact that the dimensions of charity change from time to time. However, the regulations do not articulate any standards or principles to determine how this evolutionary process is to go forward in other situations. Lord Macnaghten's standard of "benefit to the community" is not expressly stated, although it is presumably intended to be incorporated by reference as a part of the general law of charity. Accordingly, in their present form the regulations do not provide a complete definition of charity, and reference must be made to the general law of charity to determine its meaning.

All authorities agree that to define charity – that is, "to determine or fix the boundaries or extent" thereof – is an elusive task. For example, Scott states that ". . . it is impossible to frame a perfect definition of charitable purposes. There is no fixed standard to determine what purposes are charitable. . . ."[211] According to Bogert a charitable purpose is one "for the public benefit," but he states that "It is impractical to attempt to frame a definition which includes a description of all the types of activity which the courts regard as of advantage to the community."[212]

Most discussions of the concept of charity proceed by formulating lists of activities and organizations that have been accorded charitable status. Typically, such lists, although broken down into categories, are voluminous, reflecting the tremendous number and diversity of charitable organizations. The principal guides promulgated by the IRS, such as published revenue rulings and the *Exempt Organizations Handbook*, follow this pattern and catalog the various kinds of activities that have been held charitable for purposes of section 501 (c) (3). They do not, however, identify the factors common to each activity which have led all of the activities to be classified as charitable.

The Evolving Nature of "Charity"

One reason that there have been few attempts to provide a comprehensive definition is that charitable activity constantly changes, and formulating a definition is extremely difficult when the object to be defined is in flux. The evolving nature of charity is recognized by all authorities. Bogert states:

> . . . it would be inadvisable to attempt to bind the courts by a rigid formula. They should have latitude to include new purposes as society develops and public opinion changes and to exclude objectives which have become obsolete or unsuited to prevailing conditions. . . .
>
> What is charitable in one generation may be noncharitable in a later age, and vice versa. Ideas regarding social benefit and public good change from century to century and vary in different communities.[213]

Similar statements may be found in decisions of state and federal courts discussing the meaning of charity in its general legal sense. The following are typical examples:

> The enforcement of charitable uses cannot be limited to any narrow and stated formula. It must expand with the advancement of civilization and the daily increasing needs of man.[214]

> . . . the differing condition, character and wants of communities and nations, change and enlarge the scope of charity; and, where new necessities are created, new charitable uses must be established.[215]

> The definition of the term "charitable" has never been static and has been broadened in recent years.

> . . . an inflexible construction fails to recognize the changing economic, social and technological precepts and values of contemporary society.[216]

In addition to being constantly in flux, the question of what is charitable arises in a number of different contexts. Until the present century, the legal definition of charity was shaped largely by judicial decisions in thousands of cases between private litigants. These cases frequently involved the validity of a charitable bequest under attack by an heir of the testator. After property taxes became an important source of revenue for state and local governments, the question frequently arose as to whether property owned by an organization qualified for exemption from tax because it was used for charitable purposes. And with the enactment of the modern federal tax system, which bestows special benefits upon charitable organizations, another major area of controversy as to the meaning of charitable came into being.

Although the identical legal issue may be involved in many of these controversies (namely, what is the meaning of the term "charitable"), the particular context in which the question arises can have an important bearing upon the outcome. In this regard Scott comments as follows: "It is to be constantly borne in mind that a decision that a trust or organization is not exempt from inheritance or estate taxes or income taxes or property taxes is not necessarily a decision that it is not charitable."[217] Conversely, a decision that an organization is charitable within the meaning of section 501 (c) (3) does not insure that a similar conclusion will be reached for state law purposes.[218] The conflicting decisions which result from this process of adjudication make it difficult to determine in some cases whether a particular organization is or is not charitable in the generally accepted legal sense. Accordingly, while section 501 (c) (3) is to be interpreted "by reference to common-law background,"[219] that background is not sufficiently clear in all cases to provide the ultimate criterion of charity for purposes of section 501 (c) (3). As a result, a federal common law of charity appears to be emerging. In practice, this body of precedent is being shaped primarily by the administrative attitudes of the IRS, but these attitudes are subject to "correction" if they fail to give adequate recognition to the needs and values of contemporary society as perceived by the federal courts and by Congress.

As noted earlier, under the general law of charity the common element shared by all charitable organizations is that they are deemed to be beneficial to the community.[220] Since there are various types and degrees of benefit to the community, the question arises as to the extent and nature of benefit that an organization should be required to bestow upon the community in order to be recognized as charitable. The Restatement of Trusts, which reflects the general law of charity, states that no definite rule can be laid down as to this question. The Restatement advances the general proposition that "[a] purpose is charitable if its accomplishment is of such social interest to the community as to justify permitting the property to be devoted to the purpose in perpetuity."[221]

It is to be noted that this standard is framed exclusively with reference to the legal consequences which ensue under trust law when a purpose is recognized as charitable. That is, if the purpose is so recognized, the law permits the property to be dedicated to its accomplishment in perpetuity. However, under the Internal Revenue Code, there are further consequences which ensue when a purpose is recognized as charitable. These consequences are, among others, that an organization that has a charitable purpose is exempt from income tax, and persons who contribute to the organization may deduct their contributions in computing their taxable income. If the standard of community benefit set forth in the Restatement were rephrased in these terms, it would read as follows: "A purpose is charitable if its accomplishment is of such social interest to the community as to justify (i) granting tax exemption to an organization having such purpose, and (ii) permitting donors to claim a tax deduction for their contributions to the organization." It seems likely that the revised version suggested above is closer to what is in the minds of IRS officials as they act upon exemption applications in border line situations under section 501 (c) (3).[222]

The importance of the IRS in the development of the concept of charity under section 501 (c) (3) was noted by Marion Fremont-Smith in her excellent book published in 1965. She pointed out that "[t]he actual administration of the federal tax laws . . . requires a determination of validity for each new charity at the time of its creation."[223] Under our present system of tax administration, this determination is made in the first instance by the IRS in response to exemption applications filed by organizations seeking recognition of their exempt status under section 501 (c) (3).[224] Since the average organization "is not interested in the extended, expensive litigation which a resort to the federal courts entails," it is usually necessary to comply with the standards and tests laid down by the IRS in order to obtain exemption.[225]

The heavy responsibility that this system places upon the IRS appears to be recognized by that agency. In testifying before Congress in 1970, during hearings involving public-interest law firms, Commissioner of Internal Revenue Randolph W. Thrower stated:

> The Internal Revenue Service in its decisions has followed the established law. But a special problem of the Service is that the recognized needs of society and the programs designed to meet those needs have been quite varied, often experimental, and more recently have moved much faster than the development of the decisional law. This is not intended in any sense to say that any given movement is not highly beneficial but only that it involves new areas raising new questions and that there rests somewhere the responsibility of determining to what extent these efforts meet the test of being charitable. . . .
>
> By reason of the peculiar interplay between our tax laws and the development of new charitable programs, particularly where major foundation funding is essential to the program, the Internal Revenue Service frequently finds itself at the leading edge of the movement of charity into new and unexplored fields. And, as I have said, because our decisions are often accepted as conclusive, the responsibility is a heavy one.[226]

Also, in hearings before the House Committee on Ways and Means in 1972, Assistant Secretary of the Treasury for Tax Policy Edwin S. Cohen stated: "We have tried to avoid interpreting the word 'charitable' in a fixed, immutable fashion. As the courts have done in many nontax settings, we have tried to give it a meaning that changes and expands as the needs of society change and expand."[227]

In her 1965 book, Marion Fremont-Smith commented that IRS officials are oriented "toward producing revenue for the federal government" and "have not been grounded in the concepts which underlie the law of charity."[228] The above-quoted testimony of Commissioner Thrower and Assistant Secretary Cohen would seem to indicate that during the interval since the Fremont-Smith book was written, the IRS has endeavored to give greater recognition to these charitable concepts. Even so, the IRS still acts with great caution in approving the "movement of charity into new and unexplored fields."

Once exemption has been granted to an organization, its name is added to the "Cumulative List of Organizations Described in Section 170 (c) (IRS Publication 78)." This publication lists thousands of organizations which have filed exemption applications with the IRS and have been held to be exempt under section 501 (c) (3). Occasionally deletions are made from this list, as organizations have had their exemptions revoked for one reason or another.

Only a small fraction of these actions have found their way into the Internal Revenue Bulletin as published revenue rulings, which are the main source of information concerning IRS decisions under section 501 (c) (3). However, by analyzing the rulings which have been published under section 501 (c) (3) over a number of years, and the court decisions which have resulted from IRS actions, it is possible to identify certain principles which appear to guide the evolution of charity under section 501 (c) (3).

These principles may be depicted in the form of questions stated in nonlegal language as follows:

1. Does the organization meet a recognized need of the community (or an appropriate segment thereof) that would not otherwise be met through the functioning of the commercial market?
2. Are the means used by the organization to achieve its charitable purposes reasonably related to the needs that the organization is seeking to meet?
3. Does the organization manifest the characteristic of unselfish giving which has traditionally been associated with charity?
4. Is the organization consistent with law and public policy?

It would appear that if an organization can answer "yes" to each of these four questions, a rationale can probably be found to hold that the organization is charitable. On the other hand, if the answer to any of these questions is in the negative, the organization will probably not be held to be charitable.

The operation of these principles will be discussed in the succeeding portion of this Chapter. It should be emphasized that while these principles have been synthesized from court decisions and published rulings of the IRS, they have not been expressly articulated by the courts or the IRS in precisely this form as rules for determining whether an organization is charitable. They do, however, appear to be useful as a means of delineating the broad characteristics that distinguish charitable organizations from those that are not charitable under section 501 (c) (3).

A further comment should be made before discussing these principles in greater detail. That is, in determining whether an organization is "educational," "religious," or "scientific," the IRS applies tests which differ in certain respects from the principles outlined above. Accordingly, these principles are useful primarily for the purpose of determining whether an organization that cannot easily be fitted into one or more of the other categories of exempt purposes enumerated in section 501 (c) (3) can still qualify as "charitable."

Principles That Guide the Evolution of "Charity" Under Section 501(c)(3)

Does the Organization Meet a Recognized Need of the Community (Or an Appropriate Segment Thereof) That Would Not Otherwise Be Met Through the Functioning of the Commercial Market?

As previously discussed, one *sine qua non* of a charitable organization is that it confer a benefit upon the community. Certain purposes are regarded as being sufficiently beneficial to the community to be charitable *per se*. These purposes include the relief of poverty, the advancement of education and religion, the promotion of health, and governmental or municipal purposes. There are in addition many other purposes which are of such benefit to the community as to be charitable. However, there is no prescribed formula for determining what these purposes are. Scott says, for example, that this "... depends a good deal on time and place; it depends upon the views of social policy prevailing at the time of the creation of the trust. ..."[229]

As a means of gaining a better understanding of the nature of the benefit to the community which is a requisite of charitable status, it may be helpful to approach the question from the standpoint of the needs of the community. As noted earlier, the Treasury Department has stated that it has attempted to give charity "a meaning that changes and expands as the needs of society change and expand."[230]

In Webster's Third International Dictionary the word "need" is defined as "a want of something requisite, desirable or useful." It is in this sense that the word "need" is used in the present discussion. Historically, most of the needs of society have been met by the combined efforts of people and institutions operating in three major sectors – the governmental sector, the private economic sector, and the philanthropic sector.[231] A possible fourth sector comprising various nonprofit private organizations (such as labor unions, trade associations, mutual associations) is also important and can be viewed as a part of the private economic sector.

Certain types of activity have traditionally been thought of as falling clearly within the province of one of these sectors. For example, the needs of society for consumer goods (automobiles, refrigerators, toothpaste) and consumer services (laundries, filling stations, restaurants) have traditionally been met almost exclusively by the private economic sector. Certain other needs (police and fire protection, penal institutions, public schools, and others) are deemed by custom and tradition to fall within the governmental sector. Generally speaking, it has been the responsibility of philanthropy to deal with other often equally vital needs of society which are not being met adequately by private economic enterprise or government.

The close affinity between the governmental and philanthropic sectors has frequently been pointed out. In its 1952 report, the Nathan Committee stated that historically "... state action and voluntary action were not the antithesis of each other; rather they sprang from the same roots, were designed to meet the same needs and had the same motivating forces behind them – indeed, historically, state action is voluntary action crystallized and made universal."[232] As noted earlier, at the time of the Elizabethan Poor Laws and the 1601 Statute of Charitable Uses, a partnership was established between government and philanthropy for the meeting of social needs. This partnership has continued to exist in both England and America, although it has undergone many changes over the intervening centuries.

A very important aspect of this partnership is that it has traditionally been the philanthropic sector that has led the way in opening up new areas of responsibility for both government and charity. In case after case, the critical needs of society have first been recognized by the philanthropic sector, which then sought to deal with these problems through the formation of charitable institutions. Ultimately, in many situations the needs were of such magnitude and complexity that they exceeded the resources that could be marshalled by the philanthropic sector. Then it became necessary for the state to step in and assume the major responsibility.

In some cases, of course, government is unable to play a role. Religion is beyond the scope of governmental action in the United States. Also, it seems doubtful that government can adequately perform the essential task of standing aside from its own actions and critizing themin the interests of the individual citizen. Accordingly, while there is an inevitable overlap between the responsibilities of government and philanthropy, there are also areas in which the role played by one or the other will be minimal or nonexistent.

Since "lessening of the burdens of Government" is specifically enumerated as a charitable purpose in the regulations, the IRS tends to view as charitable those organizations that assist government to perform its public functions,[233] so long as such organizations are not vested with governmental powers of a type not normally possessed by charitable organizations.[234] Thus, the overlap between the governmental sector and the charitable sector does not generally present a problem with respect to the interpretation of section 501(c) (3).

In contrast to the historic kinship between the governmental and philanthropic sectors, th relationship between the philanthropic sector and the private economic sector has tended more to be one of mutual exclusion. Nevertheless, there are many areas in which the activities of these two sectors overlap, and important tax advantages depend upon whether a particular situation is placed in one category or the other. Therefore, it is necessary to have rules or principles by which to determine where the dividing line between these two sectors should be drawn. In dealing with cases which raise this issue, one important principle seems to be that an organization will qualify as charitable if its primary purpose is to meet a need that is not adequately being met by the private economic sector. This principle has been expressed by Dean Albert M. Sacks as follows:

> ...philanthropy has evolved as an adjunct of, as a supplement to, our economic system of private enterprise,... it has been thought more naturally suited to those areas where the commercial market does not operate satisfactorily to supply social needs....
>
> Our present day attitude appears to make no sharp break with past tradition, but one may discern a quickening tempo in the role of philanthropy, a greater willingness to assume new tasks accompanied by less reluctance on the part of official organs to conclude that commercial enterprise cannot discharge the entire burden.[235]

There are two aspects to the position that charity is "more naturally suited to those areas where the commercial market does not operate satisfactorily to supply social needs." The first is that where goods or services are sufficiently available (or could reasonably be expected to be made available) through the private economic sector, it is normally not charitable to engage in the business of selling such goods or services. This principle is reflected, for example, in the provisions of the Internal Revenue Code in regard to feeder organizations (section 502) and the tax on unrelated business income of 501(c) (3) organizations (sections 511-514).[236] In fact, it was the failure of the judiciary to apply this principle in several early decisions that was responsible for the enactment of these provisions in 1950.[237]

The second aspect of this position is that if there is a social need (for goods, services, or other advantages) that is not being met by the private economic sector, it may be appropriate for charity to meet this need. This is illustrated by several rulings in which the existence of such a need was apparently an important factor in IRS holdings that organizations that carry on innovative programs are exempt under one or more of the traditional categories of charity. Some of these published rulings are as follows:

Promotion of health. Exemption under section 501(c) (3) was granted to an organization formed for the purpose of providing a medical building and facilities at less than normal rates to a doctor, in order to attract a doctor to an isolated community.

The ruling stressed that the community was "[illegible]lly lacking in local medical service," and that doctors had declined to set up practice there due to the lack of office space "for carrying on a modern medical practice." The ruling also stated that "The organization is committed to review the arrangement periodically in the light of community needs and to determine, on the basis of all surrounding circumstances, whether the arrangement should be continued or modified in the light of the community needs involved. At any point at which the organization determines that adequate medical services are available to the community without the continuation of the arrangement, either through the location of additional doctors in the area or otherwise, it is committed to the termination of the arrangement. . . ."[238]

Providing legal services to the poor: Exemption was granted under section 501(c) (3) to an organization that subsidizes young lawyers for three years while they establish a practice in a depressed community so as to be able to provide free legal services to low-income clients while charging fees to others. The ruling stated that the program would be carried on in a depressed community in which there is a "shortage of available legal services."[239]

Combating community deterioration: Exemption was granted under section 501(c) (3) to an organization formed to promote the renewal of a low- income urban area which had a need for housing due to the fact that the existing housing in the area was "generally old and badly deteriorated." As part of the project, the organization purchased an apartment house which it planned to rehabilitate and rent to low- and moderate-income families in the area.[240]

Also under the category of combating community deterioration, exemption was granted under section 501(c) (3) to an organization formed to stimulate economic development in high-density urban areas by providing funds and working capital to businesses that were unable "to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing and operating enterprises in these communities. . . ." The ruling stated that in selecting recipients for aid, the organization consults with other nonprofit and governmental organizations "to identify particular undertakings that will fill a community need and offer the greatest potential community benefit." The ruling also specified that where the assistance takes the form of purchasing an equity interest, "the organization disposes of such interest as soon as the success of the business is reasonably assured."[241]

Facilitating public transportation: A charitable organization, exempt under section 501(c) (3), was permitted to make grant to a city transit authority to enable it to subsidize a privately owned bus company (which was unwilling to continue operating at a deficit) until the city could obtain the necessary funds to take over the bus company. The ruling stated that "a study by the city transit authority established that, at the level of service required by the city to meet the transportation needs of its population, public bus transportation will not maintain itself economically."[242]

New perceptions of social needs are also relied upon by the IRS in modifying the operating criteria that charitable organizations are required to meet under section 501(c) (3). For example, the IRS originally took the position that a nonprofit home for the aged did not qualify under section 501(c) (3) unless the organization furnished care and housing free or below cost.[243] Later the IRS relaxed this requirement in a ruling stating that ". . . it is now generally recognized that the aged, apart from considerations of financial distress alone, . . . have special needs because of their advanced years. . . . Satisfaction of these special needs [i.e., the needs for housing, health care and financial security] may in the proper context constitute charitable purposes or functions even though direct financial assistance in the sense of relief of poverty may not be involved."[244]

The rulings described above indicate a recognition by the IRS that the boundaries of charity may expand (or on occasion contract) in response to the changing needs of society. The IRS finds it easier to accommodate itself to this evolutionary process when the result can be rationalized by reference to one of the traditional charitable purposes (relief of the poor, promotion of health, combating community deterioration, and so forth). However, even when this cannot be done the IRS appears to be cautiously willing to permit an extension of the boundaries of charity if it is satisfied that such an extension is necessary in order to meet a need of the community that is not being met by the private economic sector.

This is illustrated by the 1970 IRS guidelines on public interest law firms,[245] as amplified by Commissioner Randolph W. Thrower's accompanying testimony before a Senate subcommittee. Commissioner Thrower's explanation of the underlying rationale of this action is enlightening. He pointed out that the new public interest law firms "litigate across a whole spectrum of concerns," including subjects such as right to work laws, decreases in railroad passenger service, protection of the environment. and protection of consumer interests. He said that "... recognizing the environment as a good cause in light of the declaration of Congressional policy would have been easy, but the principle would have been a thorny one to hold when the litigation involved a controversial or unpopular cause where there had been no expression of Congressional or Administration policy."[246]

Accordingly, the Service declined to base its recognition of the charitable status of public interest law firms upon "the merit of the designated social goals" which such firms may seek to achieve through litigation. Instead, Mr. Thrower stated that exemption was being granted "... because in this way legal representation will be made available where it has been determined in a responsible manner that there is a public, rather than a private interest, to be served through litigation. It is the availability of this type of representation that is being deemed charitable, rather than the particular cause being served, ..."[247]

Similarly, Revenue Ruling 75-74[248] points out that public interest law firms "provide legal representation on issues of significant public interest where such representation is not ordinarily provided by traditional private law firms." The ruling states that the charitable status of such firms

> ... rests not upon the particular positions advocated by the firm, but upon the provision of a facility for the resolution of issues of broad public importance....
>
> Charitability is also dependent upon the fact that the service provided by public interest law firms is distinguishable from what is commercially available....
>
> It is generally recognized that public interest representation is not ordinarily provided on a continuing basis by private law firms. [This] is primarily due to the fact that this type of representation is not economically feasible for private firms....
>
> This lack of economic feasibility in public interest cases is an essential characteristic distinguishing the work of public interest law firms from that of private firms and is a requisite of charitable recognition....

This seems to be a recognition by the IRS that there is a community need for this type of legal representation which is not being adequately met by the private economic sector. Hence, it is appropriate for charity to meet this need.[249]

While the IRS has taken this important evolutionary step, it has done so with considerable caution. This is indicated by the Service's insistence in subsequent rulings that a public interest law firm (1) can accept no fees from clients,[250] (2) can accept court-awarded fees only to the extent of 50 percent of the costs of the firm's legal functions (over a five-year period), and (3) "[a]s legal precendent is developed indicating the strong possibility of the recovery of fees, certain issues may become economically feasible for private litigants and thus inappropriate for public interest law firm participation."[251] Thus, in borderline cases the Service seems to adhere to the view that it is appropriate for charity to meet a particular need of the community only so long as it is not "economically feasible" for the private economic sector to do so. Once such economic feasibility becomes a "strong possibility," charity may be required to withdraw from the activity, according to the IRS.[252]

Since social needs appear to be a crucial factor in the evolution of charity, a question arises as to the process through which such needs become recognized as appropriate objects of charitable activity. Although this question is theoretically present in every exemption application under section 501(c) (3), it seems likely that the IRS is not required to consider it as an independent matter in a majority of cases. This is because in ruling upon such exemption applications the IRS looks first to judicial decisions and rulings under section 501(c) (3) and then to the general law of charity as developed by judicial decisions in other areas of the law, such as the law relating to charitable trusts. It would seem that most cases can be resolved by applying precedents derived from these sources.

Where this is not possible, guidance can sometimes be found in statutes enacted on the basis of legislative findings that needs exist for new programs to deal with social, economic, environmental, or other problems.[253] As legislative expressions of public policy, such statutes may provide an "official" rationale for the extension of charity into new areas, sometimes employing means that differ markedly from previous practices. The same is true of court decisions, such as *Brown* v. *Board of Education*,[254] that effect significant changes in law and social values.

However, it is inevitable that the IRS will on occasion be required to rule on the tax-exempt status of some organizations before there has been any judicial or legislative expression as to whether their programs are of sufficient public interest to warrant being classified as charitable. A similar problem can arise when organizations that have previously been recognized as charitable seek to modify their method of operation in response to the changing needs of society. Although the general law of charity does not provide a specific answer in these cases, it does supply a standard which may be applied in resolving them. This standard is expressed in the Restatement of Trusts as follows: "The question in each case is whether at the time when the question arises. . . the purpose is one the accomplishment of which might reasonably be held to be for the social interest of the community."[255]

According to the Restatement, where this standard is met, ". . . the mere fact that a majority of the people and the members of the court believe that the particular purpose of the settlor is unwise or not adapted to the accomplishment of the general purposes, does not prevent the trust from being charitable. . . . The courts do not take sides or attempt to decide which of two conflicting views of promoting the social interest of the community is better adapted to the purpose, even though the views are opposed to each other."[256]

There are indications that the IRS endeavors as a matter of policy to apply these principles in the administration of section 501(c) (3). In his testimony during the Senate subcommittee hearings on public interest law firms, Commissioner Thrower stated that the IRS does not regard its administrative role under section 501(c) (3) as being the "arbiter of the public good." He said he does not believe "that Congress wishes Internal Revenue to make such wholly subjective, *ad hoc* decision." One inference to be drawn from this statement is that the IRS does not apply its own subjective views as to community needs, or the means by which they may best be met, when it acts upon exemption applications under section 501(c) (3). At the same time, however, a strong social rationale must be provided in order to persuade the IRS to recognize a new type of charitable purpose, or to modify the criteria applicable to an existing 501(c) (3) organization so as to enable it to operate in a manner not previously regarded as charitable by the IRS.

Such a situation was considered by the Court of Appeals for the District of Columbia in *Eastern Kentucky Welfare Rights Organization v. Simon.*[257] In that case the court upheld the IRS in liberalizing the requirements that must be satisfied by a hospital in order to be recognized as charitable. Under the earlier test the IRS conditioned a hospital's charitable status upon the level of free or below-cost care that it provided for indigents.[258] Under the alternative liberalized test, the IRS held that a hospital could qualify as charitable by "operating an emergency room open to all persons, and by providing hospital care for all those persons in the community able to pay the cost thereof either directly or through third party reimbursement."[259]

The court upheld this liberalized test and rejected the contention of the plaintiffs that a charitable hospital should be required to provide free or below-cost hospital care to those unable to pay. The court stated:

> In the field of health care, the changes have been dramatic. Hospitals in the early part of this nation's history were almshouses supported by philanthropy and serving almost exclusively the sick poor. Today, hospitals are the primary community health facility for both rich and poor. Philanthropy accounts for only a minute percentage of the hospital's total operating costs. Those costs have soared in recent years as constant modernization of equipment and facilities is necessitated by the advances in medical science and technology. The institution of Medicare and Medicaid in the last decade combined with the rapid growth of medical and hospital insurance has greatly reduced the number of poor people requiring free or below cost hospital services. Much of that decrease has been realized since the promulgation of Revenue Ruling 56-185. Moreover, increasingly counties and other political subdivisions are providing non-emergency hospitalization and medical care for those unable to pay. Thus, it appears that the rationale upon which the limited definition of 'charitable' was predicated has largely disappeared. To continue to base the 'charitable' status of a hospital strictly on the relief it provides for the poor fails to account for these major changes in the area of health care.[260]

The U. S. Supreme Court has granted certiorari in the *Eastern Kentucky Welfare Rights Organization* case, and it remains to be seen whether the liberalized test for exemption adopted by the Court of Appeals in that case will be upheld. However, the opinion of the Court of Appeals illustrates the type of social, economic, or technological information that may serve as a basis for an enlargement of the concept of charity in response to the changing needs of society. In cases of this nature the task of developing such information rests primarily with the organization whose program or activity is in question. The performance of this function is a natural part of the philanthropic process. Numerous foundations and other charitable organizations devote much of their time and energy to studying the problems of society and issuing reports which recommend programs to meet these problems. It seems likely that such philanthropic studies and reports have often provided the basis for important evolutionary changes in the concept of charity under section 501(c) (3).

In close cases the IRS may conduct its own independent research, and it has on occasion invited comments from interested members of the public and governmental agencies with respect to the issues involved. This procedure was followed by the IRS in the case of public interest law firms, where it assisted in formulating a workable solution to what appeared to be a difficult problem.

Are the Means Used by the Organization to Achieve Its Charitable Purposes Reasonably Related to the Needs That the Organization Is Seeking to Meet?

The general law of charitable trusts is to the effect that if the purposes of a trust are charitable "they are no less charitable because of the means authorized to effectuate them, when . . . those means are legal and not against public policy. . . ."[261] Absent any question as to the legality of the means authorized,[262] the distinction between charitable "ends" and "means" frequently passes unnoticed in court decisions and rulings. This is perhaps due to the fact that in most cases the crucial question is whether the purposes of the organization are charitable, and the question of means is not focused upon as a separate issue.

However, if the means employed are unusual or controversial—departing from customary patterns of charitable activity—a question may be raised as to whether this prevents the organization from being classified as charitable for purposes of section 501(c) (3). The correct answer would seem to be that any means that are lawful and consistent with public policy are permissible provided they are reasonably related to a need of the community (or a segment thereof) which is a proper object of charitable concern.[263]

For example, it seems likely that an organization would not be regarded as charitable if it were formed for the purpose of providing free alcoholic beverages to needy residents of a deteriorated community. Such a means of benefiting the residents of the community would not be reasonably related to their needs. On the other hand, it could be charitable to provide free methadone in a lawful manner to drug addicts for the purpose of assisting them to overcome their addiction.

The relevance of the relationship between means and ends is recognized in a number of rulings in which the IRS approved the use of unconventional means to accomplish traditionally charitable purposes, such as advancement of education or religion, or the relief of poverty. For example, it is normally not charitable to manufacture and sell to the public goods that are like those already available on the commercial market. However, if such an operation is carried on for the primary purpose of providing vocational training and guidance to unskilled trainees (an educational purpose), the organization will be recognized as exempt under section 501(c) (3).[264]

Similarly, it is normally not charitable to carry on genealogical research with respect to the members of a particular family. But if such an activity is carried on by an organization for the purpose of furnishing to a church "genealogical information that the church needs in order to conduct certain religious ordinances in accordance with basic religious doctrine of the church," the organization will be recognized as "accomplishing a charitable purpose by engaging in an activity that advances religion."[265]

The making of loans to homeowners at prevailing bank rates is normally a commercial activity which is not exempt under section 501(c) (3). However, where this activity is carried on by an organization as a means of enabling white families to purchase homes in integrated neighborhoods, thereby helping to combat potential community deterioration (a charitable purpose expressly recognized in the regulations), the organization is deemed to be charitable.[266]

The problem becomes more difficult when nonconventional activities are engaged in for the purpose of benefiting the public in ways that have not yet been officially determined to be charitable. This was the case with respect to the proxy solicitation activities involved in *Center on Corporate Responsibility, Inc. v. Shultz.*[267] In that situation the organization wished to engage in proxy solicitation activities to achieve charitable objectives such as promoting racial equality in employment and protecting the environment. The IRS took the position that proxy solicitation activities are inherently noncharitable unless they fit into the "educational activity mold." This conclusion was rejected by the district court, which stated: "The means employed by the charitable organization to achieve its purposes do not make the end results uncharitable. So it is in this case. Proxy contests are the instruments, both legal and not against public policy, which can be used to achieve the Plaintiff's purposes."[268]

Does the Organization Manifest the Characteristic of Unselfish Giving Which Has Traditionally Been Associated with Charity?

At the beginning of his discussion of the law of charitable trusts Scott states: "For some reason best known perhaps to the psychologists most legal writers and many courts when they deal with charitable trusts, and particularly when they attempt to define them, are likely to become somewhat lyrical. Even lawyers, otherwise hardheaded, are likely to become poetic."[269]

An example of this tendency is provided by the following passage from an article written a number of years ago by Herman T. Reiling, for many years an assistant chief counsel of the Internal Revenue Service:

> Now when we turn to the law of charity, we find that the primary attribute of charity may be briefly described in two words: total unselfishness. By this, I mean unselfishness in the highest sense of the word.
>
> This quality furnishes the main theme for a classic statement by the Supreme Court that has been cited by other courts. As defined by the Court, charity is: "Whatever is given for the love of God, or the love of your neighbor, in the catholic and universal sense—given from these motives and to these ends, free from stain or taint of every consideration that is personal, private or selfish."[270]

Although Scott observes that "no definition could be worse than this," the quality of unselfishness described by Reiling does reflect something about the nature of charity which distinguishes it from activities that are not charitable. The human impulse to help one's fellow man through unselfish giving has historically been the motive force responsible for the creation of charitable institutions, and has left its imprint upon the legal criteria pertaining to such institutions. Accordingly, any attempt to define a charitable organization without taking this factor into account would seem to be incomplete.

The regulations and rulings under section 501 (c) (3) deal with this aspect of the nature of charity in two ways: First, by laying down broad rules intended to insure that charitable organizations will not be operated for selfish purposes; and second, by requiring that charitable organizations manifest to some unspecified degree the donative element which has traditionally been associated with such organizations. It is possible that the second requirement may in time become outmoded in some situations as the legal concept of charity continues to evolve in response to changing conditions in society. There is no indication that this may happen with respect to the first requirement.

The Requirement that a Charitable Organization not be Operated for Selfish Purposes. The statute provides that no part of the net earnings of a 501 (c) (3) organization may inure "to the benefit of any private shareholder or individual." Such an inurement could occur in numerous ways – as, for example, by the payment of excessive compensation for services rendered to an organization by an officer or trustee. This rule precludes many of the ways in which an organization could be operated for selfish purposes, but standing alone it is not a sufficient test for exemption under section 501 (c) (3). A broader standard of unselfishness must be met by 501 (c) (3) organizations. This is supplied by the provision in the regulations which states that an organization cannot qualify for exemption under section 501 (c) (3) "unless it serves a public rather than a private interest."[271]

In applying the rule that a charitable organization must serve a public and not a private interest, a *de minimis* exception is made for benefits that are incidental or tenuous. Thus, it is permissible for a 501 (c) (3) organization to name a building after a substantial donor even though the donor may derive an incidental benefit therefrom in the form of increased prestige.[272] Other incidental private benefits that have been held not to affect qualification under section 501 (c) (3) are illustrated by the following rulings:

> A children's day care center which is funded primarily by federal grants and selects children on the basis of need qualifies under section 501 (c) (3) even though it is operated in conjunction with an industrial company whose employees include parents of enrolled children. "[A]ny private benefits derived by the company or the parents of enrolled children is incidental to the public benefits resulting from the organization's operations."[273]
>
> An organization formed to preserve and improve a lake used extensively as a public recreational facility qualifies under section 501 (c) (3) even though lake front property owners (who contribute to part of the organization's support) derive incidental private benefits therefrom. The ruling noted that "it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners." These private benefits "do not lessen the public benefits flowing from the organization's operations."[274]

For comparison, private benefits that have prevented an organization from qualifying under section 501 (c) (3) are illustrated by the following cases:

> An organization formed to dredge a navigable waterway fronting the homes of its members was held not qualified under section 501 (c) (3). The waterway was little used by the general public, but the dredging greatly benefited the shorefront property owners, who were the only contributors to the organization.[275]
>
> Exemption under section 501 (c) (3) was denied to an organization, formed by parents of pupils attending a private school, that provided bus transportation for its members' children.[276]
>
> The same was true of an organization formed to help aspiring young entertainers, thereby benefiting the founder by providing him with performers for his radio program.[277]

A person can derive a private benefit from a payment made (or a service rendered) to someone other than himself. Thus, for example, if an organization makes loans of doubtful safety to close friends of a foundation officer, the rule against serving a private interest is violated.[278]

The existence of an employment relationship can provide a basis for a similar determination, as in the case of an organization formed and supported by a corporation (or its controlling stockholder) for the purpose of providing benefits to employees of the corporation. For example, in *Watson* v. *U.S.*, the court held that a trust established pursuant to the will of a deceased owner of a corporation was not a charitable trust for estate tax deduction purposes where the object of the trust was to pay pensions to former employees of the decedent's corporation. The court said: "We are not here dealing with an impoverished class. . . . [The pension trust] was a real part of the compensation of the employee; . . . The quid pro quo to the company was at least as important, in helping to attract desirable personnel and obtaining satisfactory results from them."[279]

The dividing line between charity and compensation is less clear where the benefit being provided is not one normally associated with the employer-employee relationship. Thus, in another case a controlling stockholder of a corporation formed an organization that provided scholarships to employees and their children. The IRS contended that the scholarship awards "were in the nature of compensation to the employees and were a benefit to the business of the companies." Such a view, if sustained, would have prevented the organization from qualifying under section 501 (c) (3). The Tax Court rejected the argument of the IRS on the nebulous ground that "it was not the intention of the trustees that the awards should constitute compensation for services or that they should constitute an inducement for an employee to remain in the service of the company by which he was employed."[280]

The possibility that company foundations may be used as a mechanism for compensating employees of the sponsoring corporation continues to be a matter of concern for the IRS. Thus, the IRS has reportedly adopted the administrative position that scholarship grants by such a foundation to children of company employees will be considered compensatory unless (1) the procedure for selecting the individuals to receive the scholarships is beyond the control of any disqualified person, and (2) no more than 25 percent of those applying for the scholarships can receive them.[281] Although the IRS has not spelled out its rationale for this position in a published ruling, it seems to be based in part upon the fact that under section 4945(g) any scholarship grant made by a private foundation must be "awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance" by the IRS. Thus, the IRS may be adopting the standards of section 4945(g) as a test for determining whether a scholarship grant made by a company foundation is consistent with the charitable status of the foundation.[282]

The requirement of serving the public interest rather than a private interest distinguishes charitable organizations from a number of other types of nonprofit entities which are exempt from tax but do not qualify under section 501 (c) (3). Such organizations include chambers of commerce, business leagues, and trade associations (exempt under section 501 (c) (6)); labor unions and agricultural associations (exempt under section 501 (c) (5)); social and recreational clubs (exempt under section 501 (c) (7)); certain social welfare organizations (exempt under section 501 (c) (4)); and employee beneficiary associations which provide life, sickness, and accident benefits to their members (exempt under section 501 (c) (9)). Many of these organizations engage in activities resembling those of charitable organizations, and some incidentally perform functions enumerated in section 501 (c) (3). However, they cannot qualify as charitable because their primary purpose is to serve, in one way or another, the mutual interests of their members.[283] Such organizations therefore lack the quality of unselfishness which is one of the traditional elements of charity.

Sometimes the lines of distinction between such organizations and those that are exempt under section 501 (c) (3) are difficult to draw. For example, many bar associations carry on a variety of activities, some of which are charitable or educational in nature (for example, extending legal assistance to indigents and conducting legal seminars and symposia) while others are directed toward furthering the common business interests of the members. The IRS takes the position that such associations cannot qualify as charitable or educational organizations under section 501 (c) (3) because they are not organized "exclusively" for such purposes.[284] However, two federal appellate courts have held to the contrary on the ground that the bar associations involved in those cases were engaged principally in activities that were of benefit to the public, and that the activities that were of benefit primarily to the members were merely incidental.[285] On the other hand, a medical society was held not to be exclusively charitable and educational because its nonqualifying activities for the benefit of its members were too substantial.[286] As Justice Blackmun stated in one of the bar association cases, the difference "may be only one of degree."[287]

The Requirement of a Donative Factor. As discussed in greater detail below, there is a strong tendency on the part of the IRS to require that a charitable organization embody to some degree a donative factor. Many charitable organizations automatically meet this requirement because they are supported primarily by contributions from persons who do not derive a private benefit from the organization.

The donative factor is strong in such organizations because they serve as a conduit whereby money or services contributed by one group of persons (financial donors and volunteer workers) are made available to another group of persons who have needs that are appropriate for a charitable organization to meet.

In contrast, there are other organizations which, although not operated for profit, do not embody any significant donative factor. Mutual organizations tend to fall in this category. There is usually no donative element associated with a mutual organization because the persons who support the organization do so with the expectation of receiving something in return, and the benefits provided by the organization flow primarily to those same persons. Accordingly, as noted earlier, mutual organizations are not charitable.

Between these two extremes are a large number of organizations which receive their support in varying degrees both from persons who derive a private benefit from the organization (that is, the users of the organization's services) and also from persons who do not derive a private benefit from the organization (that is, the contributors to the organization). As a legal matter, the IRS recognizes that "[t]he fact that an organization makes some charge for its services does not necessarily preclude qualification as a charitable organization . . ."[288] If the amount an organization charges for its services is less than the cost of providing the services, the organization is to that extent donating its services to the recipients. A donative factor is therefore evident in such an organization, although to a lesser degree than in the case of an organization that makes no charge whatever for its services. Conversely, if the amount charged by the organization equals or exceeds the costs incurred by it in providing the services, the donative factor is minimal or nonexistent. In ruling upon cases which raise this issue, the IRS is not uniform in the degree to which it requires different types of organizations to evidence a donative factor in order to qualify as charitable.

In this respect the criteria applicable to charitable organizations differ from those applicable to educational organizations, discussed later in this report. Although educational organizations customarily receive substantial donative support, and evidence a strong donative factor through the granting of scholarships and the charging of tuition fees which do not cover operating costs, they are not required to do so as a prerequisite for exemption under section 501 (c) (3). Thus, a nonproprietary educational institution which meets the other requirements of section 501 (c) (3) will not fail to qualify for exemption merely because (1) its entire support is derived from tuition and other charges paid by students, and (2) it provides no scholarships or other forms of financial aid to students who are unable to pay.[289]

The preferred position accorded to educational organizations in this respect is attributable to the fact that education is specifically mentioned as an exempt purpose in section 501 (c) (3). An organization that can meet the criteria established for educational organizations need not satisfy all of the somewhat different criteria that apply to charitable organizations.

Within the spectrum of charitable organizations that are required to manifest a donative factor to some degree, hospitals appear to be subject to the least onerous test. As previously discussed, under Revenue Ruling 69-545[290] a nonproprietary hospital that operates at an overall profit (and uses the excess funds for expansion, replacement of equipment, retirement of indebtedness, education and research) can qualify as charitable so long as it provides emergency room service to persons unable to pay, and accepts as patients all persons in the community who are able to pay either directly or through third party reimbursement.[291] However, a nonproprietary hospital that does not have an emergency room as required by Revenue Ruling 69-545 will qualify as charitable only if it is "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."[292]

In other situations, the IRS appears to require that a charitable organization make its services available at varying levels below cost. For example, as noted earlier, in the case of a nonprofit home for the aged the IRS ruled initially that charitable status was conditioned upon whether the organization provided its services gratuitously or at a charge substantially below cost.[293] This position was later modified, and the current IRS position is that a charitable home for the aged need not meet the foregoing requirements provided it charges the "lowest feasible" amount consistent with meeting the primary needs of aged persons for housing, health care, and financial security.[294] However, once such a home for the aged admits a patient on a paying basis, it cannot retain its charitable status if it later discharges him if he becomes unable to pay. To this extent the organization is required to make its services available gratuitously.

In the case of public interest law firms, discussed above, the IRS has ruled that in order to qualify as charitable such firms can accept no fees from clients and can accept court-awarded fees (paid by opposing party) only to the extent of 50 percent of the costs of the firm's litigation program, calculated over a five-year period.[295]

In Revenue Ruling 71-529,[296] the IRS ruled that an organization was charitable that provided investment services exclusively to a group of colleges and universities at a rate "substantially below cost" (that is, at a level which would cover only about 15 percent of the cost of providing the services). The IRS had previously ruled that an organization that provided investment services exclusively to 501 (c) (3) organizations for a fee (which apparently did not reflect any substantial discount from cost) was not charitable.[297]

In Revenue Ruling 73-127,[298] the IRS held that an organization that operated a retail grocery store that sold groceries to residents of a poverty area at a mark-up substantially lower than competing grocery stores was not charitable. Had the groceries been provided to needy people free of charge, or at a price substantially below cost, the organization would presumably have been charitable.

These rulings indicate that in order to qualify as charitable (as distinguished from educational) an organization is required by the IRS to evidence to some degree a donative factor through the provision of goods or services at no charge or at a charge below cost. The lightest burden appears to be imposed upon community hospitals, which are required to manifest a donative factor to the limited extent of making emergency room facilities available to persons unable to pay, while charging standard rates for all other hospital services. Homes for the aged are also subject to a minimal donative requirement. In other situations the donative element is given varying degrees of weight, depending upon the circumstances of each case. The greatest burden is imposed upon organizations that provide goods or services available in the commercial market. The IRS requires these organizations to be predominantly, if not entirely, donative in character in order to qualify as charitable. That is, they must rely almost entirely upon donations for their support, and are severely limited in the extent to which they can derive income from the performance of their exempt functions.

The effect of the varying standards evidenced by the foregoing rulings appears to be twofold, namely (1) to require charitable organizations to keep their charges as low as possible for the benefit of the public, consistent with meeting the social needs for which they have assumed responsibility, and (2) to place limitations upon the ability of charitable organizations to compete with private enterprise through the provision of goods or services available in the commercial market. Since the legal criteria for determining to what extent a particular charitable organization should be required to make its services available on a donative basis are extremely nebulous, a considerable degree of *ad hoc* line-drawing by the IRS seems inevitable in this area.

Moreover, as the criteria pertaining to charitable organizations evolve in response to changing conditions in society, it is possible that some charitable activities will be exempted from the donative requirement altogether, just as education is now so exempted. The possibility of such an extension of the bounds of charity appears to exist, for example, in the case of certain nonprofit health maintenance organizations which offer pre-paid medical care to all persons in the community who wish to subscribe and are able to pay the necessary premiums.[299]

The position of the IRS with respect to the charitable status of health maintenance organizations has not yet been published, and the answer is not clearly ascertainable from the existing precedents. On the one hand, health maintenance organizations resemble in some respects mutual associations because they serve primarily (if not exclusively) their own subscribers, and thus do not embody a donative element. On the other hand, however, they are nonprofit in nature, they operate in a traditionally charitable area (the promotion of health), and they meet a need of the community that is not adequately met by the private economic sector. Since adequate health care would seem to be as vital to the community as education, an argument can be made that health maintenance organizations that satisfy these criteria should be able to qualify under section 501 (c) (3), just as self-supporting nonproprietary educational organizations are able to do.[300]

Is the Organization Consistent with Law and Public Policy?

The Restatement of Trusts provides that "[a] charitable trust cannot be created for a purpose which is illegal."[301] In addition, the Restatement says that a trust is invalid if it is created for a purpose "the accomplishment of which is contrary to public policy, although not forbidden by law. . . ."[302]

This principle was relied upon by the IRS in Revenue Ruling 71-447,[303] holding that "a school not having a racially nondiscriminatory policy as to students is not 'charitable' within the common law concepts reflected in sections 170 and 501 (c) (3) of the Code. . . ." This ruling was based upon the premise that "[a]lthough the operation of private schools on a discriminatory basis is not prohibited by Federal statutory law, the policy of the United States is to discourage discrimination in such schools."

The issuance of Revenue Ruling 71-447 was prompted by the court proceedings in the case of *Green* v. *Connally*,[304] in which parents of Black children attending public schools in Mississippi sought to enjoin U.S. Treasury officials from according 501 (c) (3) status to private schools in Mississippi which discriminated against Black students. In the *Green* decision the court said that a "strong case" could be made for holding that segregated schools were not charitable under the common law of charity. Then the court went on to say that in view of the strong federal policy regarding racially discriminatory schools, "it is our conclusion that the ultimate criterion for determination whether such schools are eligible under the 'charitable' organization provisions of the Code rests not on a common law referent but on that Federal policy."[305]

Although public policy issues of the magnitude involved in Revenue Ruling 71-447 and the *Green* case arise only rarely under section 501 (c) (3), they can pose difficult administrative problems for the IRS when they do arise. For example, the two principal sources of federal policy referred to in Revenue Ruling 71-447 are Titles IV and VI of the Civil Rights Act of 1964 and the Supreme Court's decision banning segregated public schools in *Brown* v. *Board of Education*,[306] together with the many federal court decisions that followed it. Although the arguments in support of the ruling and the *Green* decision now seem overwhelming, it may not have been clear at the time as to exactly when, during the period from 1954 to 1970, federal policy against "discrimination in education, whether public or private"[307] became sufficiently well crystallized to justify the IRS in taking action to revoke the exemption of all-white private schools which were organized for educational purposes, were not unlawful, and met all of the other requirements of section 501 (c) (3).

In *McGlotten* v. *Connally*,[308] a federal court held that a fraternal order that excluded nonwhites did not qualify for exemption under section 501 (c) (8), and that contributions to such an order for charitable purposes were not deductible under section 170 (c) (4). One of the grounds of the decision was that "overriding public policy . . . requires that the Code not be construed to allow deduction of contributions to . . . organizations which exclude nonwhites from membership."[309] In this case, as in the *Green* case, the exemption of the organization was not challenged by the IRS but by a Black citizen who alleged that he was excluded from membership because of his race.

More recently the question of the application of this policy to the charitable activities of private foundations was considered by the U.S. Court of Appeals for the Second Circuit in the case, *Jackson v. Statler Foundation, Inc.*[310] In that case the plaintiff commenced an action against several charitable foundations alleging racial discrimination against himself, his children, and his foundation in that the defendant foundations "refused to hire him as a director of their foundations, refused to give scholarships to his children and refused to grant money to his foundation, all for reasons of race."[311] The plaintiff sought, among other forms of relief, revocation of the defendant foundations' tax exempt status under section 501 (c) (3). Without reaching the merits of the various issues, the Court of Appeals remanded the case to the district court with instructions for it to determine, in the light of guidelines set forth in the opinion, whether the action of the defendant foundations constituted "state action" for purposes of the Fifth and Fourteenth Amendments of the U.S. Constitution.

In a dissenting opinion, Judge Friendly argued against the extension of the "state action" doctrine to charitable foundations which had no governmental connection. He said:

> The interest in preserving an area of untrammeled choice for private philanthropy is very great. . . . While most foundations, particularly large ones, give mainly to institutions serving all races and creeds, although hardly in the completely nondiscriminatory way required of public institutions, I see nothing offensive, either constitutionally or morally, in a foundation's choosing to give preferentially or even exclusively to Jesuit seminaries, to Yeshivas, to black colleges or to the NAACP.[312]

These differing views illustrate the difficulty which sometimes exists in determining whether a particular organization is operating in a manner, or for a purpose, that is contrary to public policy. In the last analysis there appears to be no simple answer to the problem, and in the absence of definitive judicial or legislative guidance the IRS must of necessity act in each case in the light of its own judgment as to the policy issues involved.

IV

CRITERIA PERTAINING TO RELIGIOUS ORGANIZATIONS

Of the exempt activities enumerated in section 501 (c) (3), only religion is expressly placed beyond the limits of governmental action by the United States Constitution. The First Amendment provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof. . . ." There is, accordingly, a constitutional dimension to the phrase "religious purposes" in section 501 (c) (3) which does not exist with respect to the other exempt purposes mentioned in that section. While the Constitution does not define the term "religion," its mandate that religion shall be neither helped nor hindered by government has an influence upon the determination of what constitutes a religious purpose under section 501 (c) (3). It also raises questions regarding the constitutionality of the statutory limitations upon legislative and political activities carried on by religious organizations in furtherance of religious objectives.[313]

The Definition of "Religion" or "Religious Purposes"

> "Few would quarrel, we think, with the proposition that in no field of human endeavor has the tool of language proved so inadequate in the communication of ideas as it has in dealing with the fundamental questions of man's predicament in life, in death or in final judgment and retribution."[314]

The foregoing quotation from the 1965 decision of the U.S. Supreme Court in *United States* v. *Seeger*[315] reflects the difficulty which lawmakers and theologians alike have experienced in defining religion and distinguishing it from beliefs and practices that are not considered religious. It will be recalled that uncertainty as to the distinction between religion and "superstition," and the impermanence of any such distinction, was the reason for the omission of all references to religious purposes (other than the repair of churches) in the 1601 Statute of Charitable Uses. The Elizabethan draftsmen feared that the inclusion of religious purposes in the Statute might lead to the confiscation of trusts established for charitable purposes because "religion being variable, according to the pleasure of succeeding princes, that which at one time is held for orthodox, may at another, be accounted superstitious. . . ."[316] The attitude of the state toward unorthodox religions has of course changed greatly since 1601. From the early practice, in England and elsewhere, of requiring conformity to the orthodox religion and punishing any deviation therefrom, the law in our society has progressed to its present policy – which is to "treat all religions alike, giving the same measure of protection to all."[317]

While religious tolerance now extends to all sects, the legal concept of religion itself has remained difficult to define. Neither the Internal Revenue Code nor the regulations under section 501 (c) (3) provides a definition of "religion" or "religious purposes." Moreover, the court decisions and revenue rulings that consider the application of section 501 (c) (3) to religious organizations afford little guidance as to this fundamental question.[318] Accordingly, in order to gain an understanding of what constitutes a religion for purposes of section 501 (c) (3), it is necessary, for lack of more direct authority, to refer to the criteria that have been developed in other areas of the law.[319]

As noted previously, under the general law of charity, advancement of religion has traditionally been recognized as a charitable purpose. However, the leading treatises on the law of charitable trusts refrain from formulating a definition of religion. Bogert states that in searching for an answer to the question:

> The court will not find a guide in any definition of religion laid down by decisions or statutes, nor will it be aided to an appreciable extent by the views of theologians. It will be obliged to make a judgment based on decisions that specific gifts were of religious benefit to the public, on popular views on the subject, and its own ideas as to beliefs and practices. The attitude of any judge on such a question will depend a great deal upon his training and background. A judge living in a modern, cosmopolitan, urban district will doubtless be much more liberal in his definition of religion than will a jurist sitting in a rural neighborhood where nearly every citizen is a fundamentalist protestant christian.[320]

Scott states that a trust for the promotion of religion will be a valid charitable trust even if the particular religious sect or doctrine to be promoted has few adherents or seems to others to be "somewhat absurd." He suggests that if the tenets of a religious sect ". . . appear to be so absurd as to be irrational it is arguable that a trust to promote the religion is not a charitable trust. The difficulty is, however, that very frequently the tenets of one religion seem absurd and irrational to the adherents of other religions and to those who have no religious convictions."[321]

Until fairly recently the view was widely held that religion by its nature involves a belief in or commitment to a monotheistic God.[322] For example, in a case decided by the U.S. Supreme Court in 1890, Mr. Justice Field stated: "The term 'religion' has reference to one's views of his relations to his Creator, and to the obligations they impose of reverence for his being and character, and of obedience to his will."[323]

Similarly, Chief Justice Hughes stated in a dissenting opinion in 1930 that "The essence of religion is belief in a relation to God involving duties superior to those arising from any human relation."[324]

An important step toward a liberalized legal approach to the concept of religion was taken by the Supreme Court in 1944 in *United States* v. *Ballard.*[325] In that case the proponents of the "I Am" movement were prosecuted for mail fraud on the basis of alleged misrepresentations made by them in connection with their solicitation of funds. Among other things, the defendants were charged with having knowingly made misstatements to the effect that one of them was a "divine messenger" who had seen and spoken with Jesus Christ and who could heal those afflicted with diseases and ailments. The question considered by the Court was whether it was proper for the trial judge to have charged the jury that it was not to consider the truth or falsity of the defendants' representations but only whether the defendants held their beliefs honestly and in good faith. The Supreme Court ruled that the charge of the trial judge was proper, stating that freedom of religious belief ". . . embraces the right to maintain theories of life and of death and of the hereafter which are rank heresy to followers of the orthodox faiths. Heresy trials are foreign to our Constitution. Men may believe what they cannot prove. They may not be put to the proof of their religious doctrines or beliefs. Religious experiences which are as real as life to some may be incomprehensible to others. Yet the fact that they may be beyond the ken of mortals does not mean that they can be made suspect before the law."[326]

The *Ballard* case thus established that the content of a religious belief is no concern of the state. From there it was only a short step to the conclusion that a belief in God is not a *sine qua non* of religion in the legal sense. This step was first taken by two intermediate courts in 1957.

In *Washington Ethical Society* v. *District of Columbia,*[327] the Circuit Court of Appeals for the District of Columbia, in an opinion by then Judge Burger, held that a building used for devotional services and related activities by an Ethical Culture society qualified for property tax exemption as a building belonging to a religious society and used by its congregation for public religious worship. Judge Burger rejected the contention of the taxing authority that "religious worship" required a belief in a Supreme Being who controls the universe. "To construe exemptions so strictly that unorthodox or minority forms of worship would be denied the exemption benefits granted to those conforming to the majority beliefs might well raise constitutional issues."[328]

A California decision in the same year, *Fellowship of Humanity* v. *County of Alameda,*[329] considered the question of whether property owned by a Humanist organization qualified for exemption from local property taxes on the ground that it was used "solely and exclusively for religious worship" within the meaning of the California constitution. Rejecting the argument of the taxing authority that a theistic belief is essential to religion, the court held the property of the Humanist organization to be exempt. The court took the view that the only valid test of tax exemption in such a case is a purely objective one which ignores the content of the belief and instead inquires "whether or not the belief occupies the same place in the lives of its holders that the orthodox beliefs occupy in the lives of believing majorities, and whether a given group that claims the exemption conducts itself the way groups conceded to be religious conduct themselves."[330]

In *Torcaso* v. *Watkins,*[331] decided in 1961, the Supreme Court endorsed the view that religious belief can be nontheistic. There the Court struck down as unconstitutional a Maryland statute which barred from public office any person who refused to declare a belief in God. Writing for the Court, Mr. Justice Black stated that neither a state nor the federal government "can constitutionally pass laws or impose requirements which aid all religions as against non-believers, and neither can aid those religions based on a belief in the existence of God as against those religions founded on different beliefs."[332] He noted that "[a]mong religions in this country which do not teach what would generally be considered a belief in the existence of God are Buddhism, Taoism, Ethical Culture, Secular Humanism and others."[333]

Four years later, in *United States* v. *Seeger*,[334] the Court considered the claims of three conscientious objectors for exemption under the Uniform Military Training and Service Act from combatant service in the armed forces. The exemption applied to those who are conscientiously opposed to participation in war by reason of their "religious training and belief," defined in the act as "an individual's belief in a relation to a Supreme Being involving duties superior to those arising from any human relation, but [not including] essentially political, sociological, or philosophical views or a merely personal moral code."[335] Notwithstanding the fact that none of the claimants belonged to an organized church or religious sect, the Court held that all three claimants qualified for exemption. The Court's opinion, written by Mr. Justice Clark, reviewed "the ever-broadening understanding of the modern religious community," as to the meaning of religion and offered a test of religious belief similar to that set forth in *Fellowship of Humanity:*

> [T]he test is simple of application. It is essentially an objective one, namely, does the claimed belief occupy the same place in the life of the objector as an orthodox belief in God holds in the life of one clearly qualified for exemption?[336]

It seems likely that the foregoing test will be incorporated into section 501(c) (3). Serious constitutional questions would arise if federal tax exemption were based upon an evaluation of the beliefs espoused by a religious organization and its adherents.[337] As stated by a federal district court in a 1974 decision[338] holding the Universal Life Church to be exempt under section 501(c) (3):

> Neither this Court, nor any branch of this Government, will consider the merits or fallacies of a religion. Nor will the Court compare the beliefs, dogmas, and practices of a newly organized religion with those of an older, more established religion. Nor will the Court praise or condemn a religion, however excellent or fanatical or preposterous it may seem. Were the Court to do so, it would impinge upon the guarantees of the First Amendment.[339]

Although the element of "religious belief," as defined in the *Seeger* case, clearly seems to be a *sine qua non* of religion from the legal viewpoint, it is less clear whether anything further is required.[340] As noted previously, in *Fellowship of Humanity* the California court set forth a two-part test for property tax exemption purposes, namely (1) whether the requisite religious belief exists, and (2) whether the group that claims the exemption conducts itself in the way groups conceded to be religious conduct themselves.[341] Following this approach, the California court defined religion as follows:

> Religion simply includes: (1) a belief, not necessarily referring to supernatural powers; (2) a cult, involving a gregarious association openly expressing the belief; (3) a system of moral practice directly resulting from an adherence to the belief; and (4) an organization within the cult designed to observe the tenets of belief. The content of the belief is of no moment.[342]

This aspect of the *Fellowship of Humanity* decision appears to have attracted little attention, and it is unclear whether the elements of (1) a cult, or gregarious association, (2) a system of moral practice, and (3) an organizational structure within the cult, must be present in order for an organization to be recognized as religious for purposes of section 501 (c) (3). However, this question may not be of practical importance because most organizations that are based upon a religious belief, and have progressed to the point of applying for federal tax exemption, would probably be able to meet these requirements.[343]

Activities of Religious Organizations Not Related to Worship

The phrase "religious purposes" as used in section 501 (c) (3) is not limited to the conduct of religious worship.[344] Thus, an organization that compiles genealogical research data for members of a church in order to enable the members to perform religious rites in accordance with church doctrine is exempt under section 501 (c) (3) because it is engaged in an activity that advances religion.[345] The same is true of an organization that supervises the commercial preparation and inspection of food products to insure that they satisfy the dietary laws of a particular religion, since this activity assists adherents of the religion to observe the tenets of their faith.[346]

Many religious organizations also carry on educational and charitable activities which would be exempt under section 501 (c) (3) without reference to any religious orientation. While these organizations frequently regard their educational and charitable activities as fulfilling a religious purpose, it is usually not necessary to classify the activities specifically as being religious or educational or charitable since section 501 (c) (3) covers all three categories.

The problem of classification becomes more difficult when the activity in question is either (1) "unorthodox" (in comparison with the practices of conventional religious organizations) or (2) similar to activities that are customarily carried on for profit by commercial enterprises. Additional difficulties may be encountered when the foregoing activities are the source of significant income for the organization. Based upon the court decisions and rulings which have dealt with these problems, several general observations may be made.

First, it would appear that unorthodox religious groups are more likely to have their exemptions questioned by the IRS than are churches or organizations affiliated with the traditional, established religions. The IRS tends to view unorthodox religious groups with suspicion and is likely to challenge the tax exemption of such an organization if it believes the organization is making a "business" of religion. For example, in *Universal Life Church, Inc.* v. *United States*[347] the IRS argued that a religious organization which derived substantial revenues from the mail order issuance of ministers' credentials was not exempt. The IRS contended that this activity did not further any religious purpose and that the organization was therefore not exclusively religious. The Tax Court rejected this argument stating: "Certainly the ordination of ministers and the chartering of churches are accepted activities of religious organizations. . . . The fact that the plaintiff distributed ministers' credentials and Honorary Doctor of Divinity certificates is of no moment. Such activity may be analogized to mass conversions at a typical revival or religious crusade."[348]

Golden Rule Church Association[349] involved an unorthodox religious group which believed, among other things, that "God's laws" are intended to apply in man's business life as well as in his spiritual life. In order to demonstrate the validity of this belief, the organization acquired and operated a number of small businesses (including a nursery, a laundry, a sawmill, and a cattle ranch). These businesses were not operated for profit but for the purpose of illustrating the applicability of the "golden rule" in daily life. The IRS contended that these business activities prevented the organization from being exclusively religious as required by section 501 (c) (3). The Tax Court disagreed and noted that "an activity normally carried on to produce income may, in certain cases, be carried on exclusively for other purposes."[350] The court upheld the view of the organization that its business activities were carried on exclusively for religious purposes.

In *A.A. Allen Revivals, Inc.*,[351] the IRS challenged the exemption of a religious evangelical organization on the ground, among others, that its revenues from "faith healing" prevented the organization from being exclusively religious. This argument was rejected by the Tax Court which observed: "Reliance upon divine healing is a basic tenet of several religious organizations, among which are the Church of Christ Scientist and the Pentecostal Church of God. These religious groups subscribe to the Biblical promise of 'miraculous healing'."[352]

These and similar cases evidence an awareness of the First Amendment questions, previously discussed, which would arise if the courts adopted such a restrictive view of religion that unorthodox religious groups or practices could not qualify under section 501(c) (3) merely because they are unorthodox. Thus, in *Golden Rule Church Association* the Tax Court stated:

> We agree that religious organizations in this country do not normally run such business operations. But that is not a proper justification for our refusal to recognize that *this* religious organization did engage in its activities for exclusively religious purposes....
>
> It is a violation of the First Amendment to discriminate between religious organizations... Although tax benefits such as exemption may be matters of legislative grace... nevertheless, a denial of such benefits granted to others of essentially the same class may well rise to the level of an unconstitutional discrimination....[353]

And as stated in *Universal Life Church*, the court will not consider the merits or fallacies of a religion, nor will it "compare the beliefs, dogmas, and practices of a newly organized religion with those of an older, more established religion.... Were the Court to do so, it would impinge upon the guarantees of the First Amendment."[354]

The close scrutiny that the IRS gives to unorthodox religious organizations may evidence a concern on the part of the IRS that the exemption accorded religious organizations might be used as a vehicle for tax avoidance, or even as a kind of tax shelter for income-producing activities that are not truly religious. The difficulty is, however, that the test for determining whether an organization is religious is very broad, and any effort on the part of the IRS to apply this test too strictly, or in a selective manner, is likely to be rejected by the courts. The requirement that the earnings of a 501(c) (3) organization shall not inure to the benefit of any private individual provides some protection against abuse of the religious exemption.[355] However, in most of the cases where this argument has been made by the IRS it has been rejected by the courts.[356]

A second general conclusion which may be drawn from the existing precedents is that an organization that otherwise qualifies for exemption under section 501(c) (3) as a religious organization will not lose its exemption because it derives income from "profitable or even competitive activities in furtherance of [its] religious purpose. . ."[357] This conclusion is generally consistent with the approach followed in the statutory provision defining an unrelated trade or business. There the test is whether the trade or business in question is "substantially related" to the exercise or performance by the organization of its exempt purpose or function.[358] If the requisite relationship exists, the trade or business is not deemed to be "unrelated" and it may be carried on by the organization without loss of exemption under section 501(c) (3) and also without being subject to the unrelated business income tax imposed by section 511.

Some types of activities, such as publishing, are frequently carried on by commercial enterprises for profit and also by religious organizations in furtherance of their religious purposes. For example, the *Exempt Organizations Handbook* states: "The publication of literature is an important method of disseminating religious views. Publishing may also be a business."[359]

Whether publishing will be regarded as an exempt activity in a particular situation depends upon the facts and circumstances. Several cases have held that when the publication and sale of religious literature is part of a broader program of activities carried on for the purpose of disseminating the religious views of a 501(c) (3) organization, such publication and sale is itself an exempt activity.[360] Moreover, this is true even when the activity results in a profit, provided the objective of the activity is to advance the organization's religious purposes and not merely to make a profit.[361]

On the other hand, if the only activity of an organization is the publication and sale of religious literature at a profit, and the organization is not controlled by or otherwise related to a church or other religious body, the organization will not qualify under section 501(c) (3).[362] In *Fides Publishers Association*, holding such an organization to be taxable, the court said that if the rule were otherwise "every publishing house would be entitled to an exemption on the ground that it furthers the education of the public."[363] However, where the publication and sale of literature has a religious or educational objective, and the organization's revenues do not and are not intended to cover its costs of operation, exemption has been granted even though the organization has no denominational ties.[364]

Some religious groups or denominations carry on their printing and publication functions through a controlled subsidiary which engages in no other activities. In such a situation if the subsidiary's only purpose is to perform the religious publishing functions of the parent organization, it would seem that the subsidiary should be exempt under section 501(c) (3).[365] This would seem to be true even if the subsidiary realizes a profit from the sale of religious literature to members of the public who adhere to the religion.[366] However, if the subsidiary primarily engages in nonreligious publishing activities, and its religious publishing functions are only a minor part of its overall activities, it will not be exempt.[367]

Radio and television broadcasting is another important medium by which religious organizations can convey their views and is treated in an analogous manner to publishing.[368] Thus, the Internal Revenue Service has held that an organization that operates a radio station to broadcast worship services and other programs having religious content will qualify for exemption as a religious organization even though it operates under a commercial license from the FCC, so long as the station is nonprofit and does not sell time for commercial broadcasts and advertising.[369]

The conduct by a few religious organizations of unrelated business activities which compete with commercial enterprises has caused Congress to extend the tax on unrelated business income to churches and associations and conventions of churches in the Tax Reform Act of 1969.[370] Previously, such organizations (but not other religious organizations) had been exempt from this tax. Whether or not a business activity carried on by a church is sufficiently related to the church's religious functions to avoid being subject to the unrelated business tax will presumably be determined in accordance with the principles discussed above.

Legislative and Political Activities of Religious Organizations

An earlier part of this report[371] discusses the statutory limitations upon legislative and political activities of 501(c) (3) organizations, including those formed for religious purposes. As there noted, section 501(c) (3) provides that an organization will be denied exemption if a substantial part of its activities is attempting to influence legislation, by propaganda or otherwise, or if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.[372]

These limitations give rise to special problems when applied to churches and other religious groups, some of which take the position that they are morally compelled by the tenets of their faith to take action on legislative issues that come within the area of their religious concern. Even if such activities contravene the limitations on legislative and political action provided in section 501(c) (3), these religious groups maintain that they cannot constitutionally be denied exemption under section 501(c) (3) on this account because the First Amendment states that "Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof...."[373]

In view of the importance of this issue to religious organizations, a summation of the legal background of the problem is appropriate here.

Although churches and other religious organizations have traditionally played an active role in the process through which public issues are debated and decided in the United States, the IRS has seldom challenged the tax-exempt status of such organizations on the basis of their legislative or political activities. Until 1934 the statute did not contain any express limitation upon such activities of 501(c) (3) organizations, but the regulations provided that an organization was not educational if it was "formed to disseminate controversial or partisan propaganda...."[374]

In reliance upon this regulation the IRS denied an income tax deduction for a contribution made in 1921 to the American Birth Control League. The league, which had no religious purposes, carried on several activities that were clearly charitable, such as operating a clinic for women in need of advice as to birth control for health reasons and the publication to the medical profession of the results of the clinic's work. In addition, a major purpose of the league was to effect the repeal or amendment of state and federal statutes dealing with the prevention of conception.

In *Slee v. Commissioner*[375] the Court of Appeals for the Second Circuit, in an opinion by Judge Learned Hand, held that the Birth Control League's legislative purpose prevented it from being exclusively charitable. Judge Hand conceded that "there are many charitable, literary and scientific ventures that as an incident to their success require changes in the law." He noted, for example, that a society for the prevention of cruelty to children or animals "needs the positive support of law" and "does not lose its character when it seeks to strengthen its arm."[376] In such a situation, the organization's activities to influence legislation "... are mediate to the primary purpose, and would not, we should think, unclass the promoters. The agitation is ancillary to the end in chief, which remains the exclusive purpose of the organization."[377]

However, Judge Hand concluded that this rationale did not apply to the legislative activity of the Birth Control League since such activity "was not confined solely to relieving its hospital work from legal obstacles."[378] He therefore viewed the legislative activity of the Birth Control League as a separate purpose which prevented the league from being exclusively charitable. Judge Hand said: "Political agitation as such is outside the statute.... Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them."[379]

The *Slee* case involved an organization that had no connection with a religious purpose. However, in *Girard Trust Co. v. Commissioner*[380] the IRS attempted to extend the principle of the *Slee* case to a religious organization by denying an estate tax deduction (under the Revenue Act of 1926) for a bequest to the Board of Temperance, Prohibition and Public Morals of the Methodist Episcopal Church. The reason for the proposed disallowance was that the board, which was an auxiliary of the Methodist Episcopal Church, engaged in substantial activity to promote the enactment of temperance legislation.

The Court of Appeals for the Third Circuit upheld the deduction on the ground that the board's advocacy of temperance legislation was an activity that had been "regarded as religious by the Methodist Church for a century and a half."[381]

> Religion includes a way of life as well as beliefs upon the nature of the world.... The step from acceptance by the believer to his seeking to influence others in the same direction is a perfectly natural one, and it is found in countless religious groups. The next step, equally natural, is to secure the sanction of organized society for or against certain outward practices thought to be essential....
>
> Surely a church would not lose its exemption as a religious institution if, pending a proposal to repeal Sunday observance laws, the congregation held a meeting on church property and authorized a committee to appear before a legislative body to protest against the repeal....[382]

Finding the Board of Temperance to be a religious organization, the majority concluded that a "limitation, if any, upon the deduction granted in general terms of bequests to religious bodies is for Congress to make...."[383]

In *Lord's Day Alliance of Pennsylvania* v. *United States*[384] a federal district court followed the *Girard Trust Co.* case in upholding the exemption (from Social Security tax) of a religious organization "engaged in promoting the reverent observance of The Lord's Day, commonly called Sunday...." The IRS contended that the Lord's Day Alliance was not exempt as an exclusively religious organization because it carried on an active program of opposing legislation that would lessen the observance of Sunday as a holy day. The court held that the alliance qualified for exemption because its legislative activities (1) were not substantial, and (2) were "incidental to the aims and objects of the organization, and did not, as in the case of *Slee* v. *Commissioner*..., constitute its primary purpose."[385]

Following the Service's defeat in *Girard Trust Co.* and *Lord's Day Alliance*, there were no further court contests involving legislative or political activities of a religious organization until the IRS revoked (in the early 1960s) the exemption of Christian Echoes National Ministry, Inc., a nonprofit religious corporation organized by Dr. Billy James Hargis. By the time this case arose, section 501(c) (3) had long since been amended to include specific limitations on legislative and political activities. Accordingly, the question of the constitutionality of these limitations as applied to a religious organization was directly raised for the first time in the *Christian Echoes* case.[386]

Christian Echoes was a staunchly anti-Communist religious organization whose articles of faith contained a commitment to fight "atheistic world forces [which] seek the destruction and overthrow of all the religions of the World, including particularly that founded upon the teaching of Jesus Christ."[387] Its mission was described by its founder as a battle against communism, socialism, and political liberalism which it considered arch enemies of the Christian faith. In promoting its articles of faith it conducted religious "revivals, rallies, Sunday worship services and other functions usually performed by a local church of the Christian gospel."[388] It also maintained religious radio and television broadcasts and published two magazines and a newspaper column.

In 1953 Christian Echoes was granted exemption by the IRS under the predecessor of section 501(c) (3) as a corporation organized and operated exclusively for religious and educational purposes. Eleven years later the IRS revoked the exemption on the ground that Christian Echoes engaged in substantial activity aimed at influencing legislation and directly intervened in political campaigns on behalf of candidates for public office. In a suit brought by Christian Echoes for refund of Social Security taxes, the district court upheld its claim for refund and ruled that the exemption had been improperly revoked. Adopting a narrow interpretation of the relevant statutory language, the district court found that no substantial part of the activities of Christian Echoes had been devoted to attempts to influence legislation or intervene in political campaigns and that such of its activities as had been so characterized by the IRS were merely incidental to the exercise of its religious beliefs.[389] The district court also stated that the IRS was constitutionally prohibited from examining the activities of a religious organization for the purpose of determining whether the activities are religious or political, and if political, whether substantial.[390]

The district court's decision was unanimously reversed by the Court of Appeals for the Tenth Circuit, which stated:

> A religious organization that engages in substantial activity aimed at influencing legislation is disqualified from tax exemption, whatever the motivation. The Government has at all times recognized Christian Echoes as a religious organization. Indeed, the Government acknowledges that in all of its activities, Christian Echoes has been religiously motivated....
>
> If we were to adopt the District Court's findings and the arguments advanced by Christian Echoes, we would be compelled to hold that Congress is constitution-

> ally restrained from withholding the privilege of tax exemption whenever it enacts legislation relating to a nonprofit religious organization.... Such conclusion is tantamount to the proposition that the First Amendment right of free exercise of religion, ipso factor, assures no restraints, no limitations and, in effect, protects those exercising the right to do so unfettered. We hold that the limitations imposed by Congress in Section 501(c) (3) are constitutionally valid. The free exercise clause of the First Amendment is restrained only to the extent of denying tax exempt status and then only in keeping with an overwhelming and compelling Governmental interest: That of guarantying that the wall separating church and state remain high and firm. We reject both the District Court's findings and conclusions on the First Amendment constitutional issue....[391]

In essence, the circuit court concluded that tax exemption is a matter of grace rather than right, and that Christian Echoes could constitutionally be required to choose between engaging in attempts to influence legislation without the benefit of tax exemption on the one hand, and enjoying tax exemption but refraining from such activities on the other.

The Supreme Court declined to grant certiorari in the *Christian Echoes* case.[392] Accordingly, the important constitutional issue presented by that case has not yet been definitively resolved. Moreover, the opinions of the two lower courts failed to discuss certain constitutional aspects of the case which would appear to merit closer consideration.

The first of these is the effect of *Walz* v. *Tax Commission* [393] upon the grant of tax-exempt status to religious organizations. In *Walz* the Supreme Court held that the Establishment Clause of the First Amendment was not violated by the grant of property tax exemption to religious organizations under a law of the State of New York which also exempted property owned by a broad range of charitable, educational, and other nonprofit, quasi-public corporations.

The opinion of the Court, written by Chief Justice Burger, commented upon the "tight rope" that the Court is sometimes required to traverse in dealing with questions of church-state relationships. The Chief Justice noted that the Establishment and Free Exercise Clauses of the First Amendment are not precisely drawn, and that the Court has struggled to find a neutral course between the two, "both of which are cast in absolute terms, and either of which, if expanded to a logical extreme, would tend to clash with the other."[394]

The following quotation from the opinion indicates the approach followed by the Court in such cases:

> The course of constitutional neutrality in this area cannot be an absolutely straight line; rigidity could well defeat the basic purpose of these provisions, which is to insure that no religion be sponsored or favored, none commanded, and none inhibited. The general principle deducible from the First Amendment and all that has been said by the Court is this; that we will not tolerate either governmentally established religion or governmental interference with religion. Short of those expressly prescribed governmental acts there is room for play in the joints productive of a benevolent neutrality which will permit religious exercise to exist without sponsorship and without interference.
>
> Each value judgment under the Religion Clauses must therefore turn on whether particular acts in question are intended to establish or interfere with religious beliefs and practices or have the effect of doing so. Adherence to the policy of neutrality that derives from an accommodation of the Establishment and Free Exercise Clauses has prevented the kind of involvement that would tip the balance toward government control of churches or governmental restraint on religious practice.[395]

The Court concluded that the New York statute met the foregoing standard of neutrality because the "purpose of the property tax exemption is neither the advancement nor the inhibition of religion; it is neither sponsorship nor hostility."[396] However, the Court also stated that this did not end the inquiry: "We must also be sure that the end result – the effect – is not an excessive government entanglement with religion. The test is inescapably one of degree. Either course, taxation of churches or exemption, occasions some degree of involvement with religion."[397]

Concluding that the exemption of churches "creates only a minimal and remote involvement between church and state and far less than taxation of churches," the Court upheld the exemption.[398]

The foregoing background would appear to have an important bearing upon the question of whether religious organizations are constitutionally free to engage in legislative and political activities without loss of their favored tax status under the Internal Revenue Code. In resolving this question, it would seem necessary to consider the combined effect of (1) the Religion Clauses of the First Amendment (which apply to religious organizations but not to other 501 (c) (3) organizations) and (2) other constitutional guarantees, such as free speech, due process and equal protection of the laws (which presumably apply to secular as well as to religious 501 (c) (3) organizations).

Insofar as the Religion Clauses of the Constitution are concerned, it is possible that the principle of neutrality discussed above may require that the questions under consideration be determined in the same manner for religious organizations as for other 501 (c) (3) organizations – that is, with no substantial advantages or disadvantages applied to religious organizations merely because they are religious. For example, it seems doubtful that the Constitution would permit religious organizations to be denied exemptions under section 501 (c) (3) on the basis of their legislative activities if other 501 (c) (3) organizations were permitted to engage in such activities and retain their exemption. Such an obvious discrimination against religion would seem difficult to reconcile with the principle of neutrality enunciated in the *Walz* case. Conversely, a question may also exist as to whether religious organizations could constitutionally be given preferred tax treatment insofar as legislative activities are concerned. If religious organizations that engage in such activities were accorded valuable tax advantages while other 501 (c) (3) organizations were denied these advantages, the resulting preference in favor of religion might be regarded as a violation of the principle of neutrality.

Moreover, preferred tax status for legislative or political activities of religious organizations might be viewed as creating a risk of excessive entanglement of government and religion since its effect could be to enable, or possibly to encourage, religious organizations to engage in legislative or political activities that would not be permitted in the case of other 501 (c) (3) organizations. In his concurring opinion in the *Walz* case, Justice Harlan noted that ". . . religious groups inevitably represent certain points of view and not infrequently assert them in the political arena, as evidenced by the continuing debate respecting birth control and abortion laws. Yet history cautions that political fragmentation on sectarian lines must be guarded against."[399]

Also, the Supreme Court stated in *Cammarano* v. *United States*[400] that ". . . since purchased publicity can influence the fate of legislation which will affect, directly or indirectly, all in the community, everyone in the community should stand on the same footing as regards its purchase so far as the Treasury of the United States is concerned."[401] Accordingly, the Supreme Court might view with concern a situation in which religious organizations were encouraged by the tax laws to engage in legislative or political activities while similar encouragement was withheld from other 501 (c) (3) organizations.[402]

If, as suggested above, the Religion Clauses of the First Amendment require substantially neutral tax treatment as between religious organizations and other 501 (c) (3) organizations insofar as their legislative and political activities are concerned, the question is raised as to whether the existing restrictions on legislative and political activities are constitutional as applied to the broad range of 501 (c) (3) organizations. This is an extremely complex question which surprisingly has received little consideration by the courts.[403] However, commentators have suggested that the limitations on legislative (as opposed to political activities may well be unconstitutional.[404] The major arguments advanced in support of this position may be summarized in greatly simplified form as follows:

1. Under the general law of charity, lobbying (or advocacy of legislation before legislative bodies) can be an appropriate means of accomplishing charitable, religious, educational, or other purposes enumerated in 501 (c) (3). Thus, a 501 (c) (3) organization does not necessarily remove itself from the exempt class merely because it engages in substantial legislative activity.

2. Such legislative activity falls within the protection of the First Amendment, which provides that "Congress shall make no law . . . abridging the freedom of speech or of the press, or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances."

3. While organizations referred to in section 501 (c) (3) do not have a constitutional right to be exempt from federal income tax (or to receive deductible contributions from donors), these tax benefits cannot constitutionally be denied such organizations on the basis of their exercise of First Amendment rights, since to do so would, in effect, penalize them for exercising such rights.

4. Even if the Constitution would permit an across-the-board denial of all tax benefits to all taxpayers (whether business corporations, exempt organizations, charitable donors, or others) on account of legislative expenditures, the Internal Revenue Code does not achieve this result. Instead, the Code allows tax benefits for legislative expenditures in the case of some taxpayers but not others, and in the area of exempt organizations the restrictions on legislative activities are not uniform, thus discriminating against some organizations and favoring others. For example: business corporations are allowed by section 162(e) to deduct their direct lobbying expenses; veterans organizations and fraternal beneficiary societies are not subject to statutory limitations on lobbying, although they enjoy essentially the same tax advantages as 501 (c) (3) organizations; labor and agricultural organizations and trade associations carry on lobbying activities, yet they are exempt from tax and their members can deduct their payments to such organizations; under the "no substantial part" test of section 501 (c) (3), large organizations can carry on more extensive legislative activities than small organizations, thus placing the latter organizations (which frequently represent minority, or even unpopular, viewpoints) at a disadvantage.

5. As a result of changes in the tax law since 1934, a large number of taxpayers are now allowed to engage in substantial lobbying activities with tax deductible funds, or within the framework of a tax-exempt entity. This demonstrates that there is no compelling governmental interest in denying this privilege to 501 (c) (3) organizations. These developments have undermined Judge Hand's statement in the *Slee* case, which was quoted with approval by the Supreme Court in *Cammarano* v. *United States*, that legislative controversies "must be conducted without public subvention; the Treasury stands aside from them."[405] In fact, the Treasury does not stand aside in many situations but throws its weight unequally behind one side of the controversy but not the other, depending upon the tax status of the parties involved. Under these circumstances, the denial of an equal right to 501 (c) (3) organizations to engage in lobbying activities cannot be constitutionally justified.

6. Even if it is assumed that Congress may validly impose some type of reasonable limitations upon the right of 501 (c) (3) organizations to engage in legislative activities, the limitations in their present form are void for vagueness and overbreadth. The

ambiguities inherent in phrases such as "no substantial part of the activities" and "carrying on propaganda or otherwise attempting to influence" are so great that 501(c) (3) organizations are left with virtually no guidance as to what conduct they can engage in. This type of "extraordinary ambiguity" has on several occasions been held unconstitutional in laws affecting the exercise of First Amendment rights.

7. Moreover, the sanction that section 501(c) (3) imposes upon organizations that engage in legislative activities is excessive when compared with the sanction imposed upon business corporations whose legislative activities exceed the bounds of section 162(e). In the latter situation the only penalty is disallowance of the specific expenditure which cannot be deducted under section 162(e). A much more drastic penalty is imposed upon 501(c) (3) organizations–namely, loss of 501(c) (3) status and loss of the right to receive tax dedutible contributions from donors. The Supreme Court has stated: "[E]ven though the governmental purpose be legitimate and substantial, that purpose cannot be pursued by means that broadly stifle fundamental personal liberties when the end can be more narrowly achieved. The breadth of legislative abridgment must be viewed in the light of less drastic means for achieving the same basic purpose."[406]

This suggests that any valid limitation upon the right of 501(c) (3) organizations to engage in lobbying activities should be narrowly drawn so as to affect only those activities (or expenditures) that exceed the limitation. The present statute fails to meet this test.

It is clear that constitutional questions such as these can be answered with finality only by the Supreme Court. Moreover, the problem may be so complex--and so interwoven with the tax treatment of other entities that engage in lobbying activities--that a purely judicial solution is not practicable. The courts must of necessity deal with constitutional issues on a case-by-case basis, and in the present context they may be unable to draw the lines which need to be drawn in order to safeguard the exercise of basic constitutional liberties and at the same time protect the legislative process against the unfair "tilting" which might result if substantially uniform tax treatment is not accorded all categories of taxpayers that carry on or support lobbying activities. It would seem, therefore, that Congress has a responsibility to enact a more coherent set of rules to deal with this important question.[407]

V

CRITERIA PERTAINING TO EDUCATIONAL ORGANIZATIONS

Few objectives are valued more highly by society than education. As expressed by Bogert:

> The ideal of the law is that all members of society shall be wise, well-trained and cultured.[408]
>
> Whatever results in the spread of knowledge, the dissemination of useful information, the training and discipline of the mind, the discovery of the truth, and in the accomplishment of numerous similar ends, increases culture and extends civilization, and obviously is of the highest value to mankind.[409]

Among the purposes mentioned as charitable in the 1601 Statute of Charitable Uses were the maintenance of "schools of learning, free schools and scholars in universities" and the "education and preferment of orphans." Thus, it has always been clear under the general law of charity that the advancement of education is a charitable purpose.[410] The same policy is carried forward in section 501(c) (3), which exempts organizations formed exclusively for educational purposes.

As we have previously seen, a great deal of controversy has arisen as to the legal meaning of the terms "charitable" and "religious." By comparison, the formulation of a workable definition of the term "educational" appears to have been accomplished with relative ease. A possible reason for this is suggested by the following quotation from an article by Dean Albert M. Sacks:

> Education does differ, however, from the other traditional classes of philanthropy in one vital respect. The latter represent social objectives in defined subject matter areas – e.g., relief of poverty, advancement of religion, improvement of health – deemed to be of such public benefit that activity in such areas is favored, and the method used is immaterial so long as it is lawful. Education, on the other hand, falls into no such defined area and has no subject matter goal. It is essentially a process or series of processes capable of being utilized with any subject matter. Thus, in seeking to determine whether an activity is "educational" we need to focus on the process being used, not the subject matter objectives being pursued.[411]

The regulations under section 501 (c) (3) implicitly reflect this view and provide the following definition:

> Educational defined. – (i) In general. – The term "educational," as used in section 501 (c) (3), relates to–
>
> (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
>
> (b) The instruction of the public on subjects useful to the individual and beneficial to the community.
>
> An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.[412]

The regulations then go on to provide the following examples of organizations that are considered to be educational:

> *Examples of educational organizations.* The following are examples of organizations which if they otherwise meet the requirements of this section, are educational:
>
> *Example (1).* An organization, such as a primary or secondary school, a college or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.
>
> *Example (2).* An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.
>
> *Example (3).* An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.
>
> *Example (4).* Museums, zoos, planetariums, symphony orchestras, and other similar organizations.[413]

An analysis of the major elements of the definition of "educational" in the regulations will provide a view of the breadth and diversity of organizations that have qualified under this provision.

The Element of Training or Instruction

Under the foregoing regulations, emphasis is placed upon the function of training or instruction, either of the individual for the purpose of improving or developing his capabilities or of the public on subjects useful to the individual and beneficial to the community. It is important to note, however, as Dean Sacks has pointed out, that

> Education in our society stands for more than a training function. The term itself ought not to be defined in some abstractly logical way, but by reference to those activities which in our society are carried on by accepted centers of education. We all agree that the activities of our colleges and universities are "educational." University activities are not limited to the training function; they include as an integral part the functions of research and publication of findings and conclusions – in other words, the development of new knowledge and the dissemination of both new and old knowledge even beyond the university walls.[414]

In its rulings under section 501 (c) (3), the IRS has accepted the broader view of education espoused by Dean Sacks. Thus, the IRS has stated, for example, that an organization may qualify as educational "even though it does not offer formal instruction or training, but merely provides an opportunity for an individual to educate himself through observation of, or participation in, the organization's activities."[415]

The IRS has also held in several rulings that cultural organizations devoted to the promotion of the arts may qualify as "educational or charitable" even though they do not carry on formal instructional or training programs. Thus, exemption has been granted to nonprofit organizations such as the following: An organization that sponsors an annual art exhibit at which works of unknown but promising artists are displayed;[416] a permanent touring theatre repertory company;[417] an organization formed for the promotion of the arts by encouraging local repertory theatre groups;[418] an organization created to develop and promote an appreciation of jazz music as an American art form through the presentation of public jazz festivals;[419] an organization formed to promote group harmony singing through meetings, practice sessions and public concerts.[420]

The regulations refer to other types of organizations that are deemed to be educational even though they do not necessarily provide formal training or instruction, such as museums, zoos, planetariums, symphony orchestras, and similar organizations.[421] This category has been extended by rulings to embrace organizations such as a bird and wildlife sanctuary,[422] an agricultural fair,[423] and a sports museum.[424]

The IRS has also ruled that a 501 (c) (3) organization may properly make so-called "creative" grants to writers, painters, composers, sculptors, and scholars for projects in their respective fields which they would not otherwise be able to undertake or finish due to lack of funds.[425] Such grants differ from traditional scholarship and fellowship grants in that they are not given to enable the recipient to pursue a course of study or instruction at an educational institution. Nonetheless, they have an educational purpose because they promote culture and the arts and also enable the recipient to develop his talents through independent work or study.

The foregoing rulings indicate that cultural, artistic, and analogous activities are presumed by the IRS to be educational without regard to whether they are accompanied by a formal program of training or instruction. However, this presumption does not extend to other types of activity, such as, for example, sports. Unlike the promotion of culture (which is deemed to be educational *per se)*, the promotion of a sport for amateurs has been ruled by the IRS to be outside the scope of section

501 (c) (3).[426] Similarly, although the IRS has ruled that mere participation in the reenactment of Civil War battles has educational value,[427] this is not true of mere participation in amateur baseball games. Accordingly, an amateur baseball league cannot qualify under section 501 (c) (3) and must obtain its tax-exempt status under section 501 (c) (4).[428] The rationale given by the IRS for this position is that amateur sports "neither improve nor develop the capabilities of the individual nor instruct the public on subjects useful to the individual and beneficial to the community within the meaning of the regulations. Therefore, these activities are not educational within the meaning of section 501 (c) (3) of the Code."[429]

It may be concluded from the foregoing that two principal categories of activities are deemed to be educational *per se*. These are (1) instruction or training which meets the broad tests set forth in the regulations, and (2) the promotion of culture and the arts (where the element of instruction or training either is not required or is presumed to be satisfied by reason of the high value that society places upon art and culture).[430]

Criteria for Determining Whether Training or Instruction Is "Educational"

The criteria for determining whether an activity qualifies as "training or instruction" (so as to be "educational" for purposes of section 501 (c) (3)) are extremely broad. The regulations make clear that educational activity may be directed toward the individual or toward the public at large. If directed toward the individual, the purpose must be to improve or develop his capabilities. If directed toward the public, the subject matter of the instruction must be "useful to the individual and beneficial to the community." In addition, if an organization advocates a particular position or viewpoint, the pertinent facts must be fully and fairly presented in order to enable the individual or the public to arrive at an independent judgment. These criteria will be examined as they relate to the subject matter of instruction, the method of instruction, and the requirement of a full and fair presentation of the pertinent facts.

The Subject Matter of Instruction

Assuming compliance with law and public policy, there appear to be few subjects that are so completely lacking in usefulness or benefit to society as to be beyond the limits of "education" as defined in the regulations. A multitude of topics have been recognized as being appropriate subjects of education for this purpose. It seems clear that any subject that is included in the curriculum of an accepted center of education – such as a college, university, secondary school – is educational. However, the scope of what is educational under section 501 (c) (3) is far broader than that, as is indicated by the following cross section of activities that have been ruled to be educational for this purpose:

Training or Instruction of Individuals. Instructing farmers, workers and small businessmen in developing nations regarding techniques for organizing and managing credit unions;[431] instructing doctors concerning recent scientific developments in the field of medicine;[432] instructing expectant mothers concerning methods of painless childbirth;[433] instructing employees of banks on various banking subjects;[434] instruction regarding sports and athletics[435] (as distinguished from mere promotion of sports); counseling men regarding voluntary sterilization methods;[436] counseling women with unwanted pregnancies regarding alternative ways of resolving such pregnancies;[437] providing vocational training to non-skilled persons;[438] providing marriage counseling,[439] providing instruction on how to remedy adverse effects of drugs;[440] providing vocational counseling;[441] training prisoners regarding constructive social behavior;[442] training apprentices in skills and crafts.[443]

Instruction of the Public. Instructing the public on personal budgeting, buying practices and the sound use of credit;[444] instructing the public regarding standards of safety in the design, construction, and operation of small craft;[445] educating employers regarding the advantages of nondiscriminatory hiring practices;[446] educating the public in the advantages of tree planting;[447] educating the public as to quality radio and TV programs;[448] educating the public regarding the need for a code of fair campaign practices;[449] educating the public regarding the accuracy and fairness of news reports.[450]

It would appear from these rulings that educational organizations are seldom denied educational status because the subject matter of the training or instruction is not sufficiently worthwhile. However, inadequacy of educational content appears to have been a significant factor in a few rulings. For example, the IRS has ruled that a nonprofit organization that conducts obedience training classes for dogs and their owners is not "educational" under section 501 (c) (3).[451] The ruling stated: "While the owner receives some instruction in how to give commands to his dog, it is the dog that is the primary object of the training."[452]

Also, in a ruling denying educational status to a college discussion group the IRS stated:

> The various topics that thus become the subject of speeches and discussions do not fall within any particular or identifiable fields of inquiry. Nor is there any evidence that the discussions communicate any organized body of knowledge or information that would develop or improve the individual capabilities of the participants to a significantly greater extent than that normally attending exchanges of personal opinions and experiences in the informal atmosphere commonly characterizing meetings of social and fraternal groups or professional clubs.[453]

The fine line that distinguishes "education" from mere "exchanges of personal opinions and experiences" is illustrated by comparing the foregoing ruling with another ruling in which the IRS granted 501 (c) (3) status to a "coffee house" formed by a group of churches. The coffee house was deemed to be advancing education and religion "by providing an environment in which young adults are brought together with church leaders and other community leaders for meaningful discussions and counseling on religion and other matters of moral and intellectual value."[454]

It is possible that the difference in the result reached in these two rulings was not attributable so much to differences in the educational content of the discussions as to the fact that the exempt coffee house was sponsored by a group of churches whereas the nonexempt college discussion group held no formal ties with an established 501 (c) (3) organization.

The Educational Method

The regulations do not require an educational organization to follow any prescribed method in achieving its goal of instruction or training. Since traditional institutions of formal education – such as trade schools, secondary schools, colleges, and professional schools – are presumed to be educational under the regulations, it would appear that any reasonable method for advancing knowledge employed by such institutions would be permissible under section 501 (c) (3).[455]

The regulations also recognize as "educational" certain widely used and accepted teaching techniques, such as public discussion groups, forums, panels, lectures (which may be presented, but need not be, on radio or television), and courses of instruction by means of correspondence or through the utilization of television or radio.[456] To this list may be added certain other commonly used methods of instruction or dissemination of knowledge such as the publication of newsletters and pamphlets,[457] the maintenance of a library,[458] the conduct of factual inquiries and the issuance of reports,[459] the presentation of workshops, conferences and exhibits,[460] the collection of materials of historical interest for donation to a university or library,[461] and the production and distribution of educational films.[462]

The foregoing enumeration is not all-inclusive and it would seem that virtually any reasonable means of achieving the objectives of training or instruction contemplated by the regulations will be recognized as "educational" so long as it is lawful and consistent with public policy. Examples of unconventional educational programs that have been recognized by the IRS include operation of a toy manufacturing business (for the purpose of providing job training to unskilled individuals),[463] organization and conduct of travel study tours;[464] operation of a government internship program for college students;[465] working in a political campaign on behalf of a candidate for elective office (as a part of a college course in political science);[466] management of an investment portfolio (as a part of a college course on investments);[467] sponsoring public concerts and arranging concert bookings to enable aspiring performing artists to obtain experience needed in order to develop their talents and become self-supporting professionally.[468]

Personal counseling can also constitute a valid educational method for purposes of section 501 (c) (3). However, whether or not it will be so recognized in a particular case depends upon the subject matter and purpose of the counseling. The IRS has ruled that the provision of free personal counseling to individuals who are in various forms of "distress" is educational, such as counseling former mental patients to become self-supporting members of society,[469] counseling users of mind-affecting drugs as to means of counteracting such drugs,[470] counseling prisoners concerning psychological needs,[471] counseling poor people concerning personal budget problems,[472] counseling individuals in regard to marital difficulties,[473] and counseling women regarding alternative means of resolving unwanted pregnancies.[474]

It will be noted that in the above situations the counseling is directed at persons who have specific needs of the type that are traditionally met by charitable activity. In such cases, the counseling may be viewed as serving a charitable purpose as well as an educational purpose. On the other hand, the provision of free counseling to members of the public who are in financial difficulties (although not in the poverty class) has been ruled to be neither educational nor charitable.[475] While the distinction between educational and noneducational counseling has not been precisely articulated by the IRS, it would seem to depend upon whether one of the two alternative standards set forth in the regulations is met, namely whether the purpose of the counseling is to improve or develop the capabilities of the individual or to provide instruction on subjects useful to the individual and beneficial to the community. Counseling that does not meet either of these tests would presumably not be educational, although it might in proper circumstances be charitable, as in the case of legal counseling provided free of charge to poor people.

The Requirement of Full and Fair Exposition of the Relevant Facts

While education by its nature involves the dissemination of knowledge, ideas, and information, not every such dissemination qualifies as "educational" for purposes of section 501 (c) (3). The basic criterion of an educational presentation has been described by Dean Sacks as follows: "". . . In order to be educational, the presentation must utilize a form to some not easily defined extent which gives its audience an opportunity to think about and to evaluate its merits . . . An organization which utilizes truly educational methods is necessarily removed to some extent from an action program, for it must leave the question of action to its audience upon a fair presentation. The matter is one of degree and the precise line is very unclear."[476]

For many years the regulations attempted to deal with this aspect of the definition of an educational organization by excluding therefrom organizations formed to disseminate "controversial or partisan propaganda."[477] This language had little to recommend it as a legal criterion, for as Judge Learned Hand stated in *Slee* v. *Commissioner* "propaganda" is a "polemical word used to decry the publicity of the other side."[478]

In 1959 the regulations were amended to adopt the present test which reads as follows:

> An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.[479]

The key words in this regulation are "a sufficiently full and fair exposition of the pertinent facts to permit an individual or the public to form an independent conclusion." The application of such a standard is a matter of judgment and depends upon the facts and circumstances of each situation. Thus, a presentation to an audience which has expertise in the subject being discussed should not necessarily be required to adopt the same form and tone as a presentation to the general public. Moreover, there is no mechanical test by which to determine whether a presentation which advocates a particular viewpoint is sufficiently well documented, or gives sufficient consideration to the opposing viewpoint, to qualify as educational.[480]

Although the regulation was adopted in 1959, there is virtually no published authority dealing with the difficult questions of interpretation to which it could give rise. If the regulation were applied in a technical fashion, it could provide fertile ground for innumerable controversies as to whether, in a particular situation, an organization that utilizes the mass media to educate the public concerning a controversial topic meets the standard of a "full and fair" presentation.[481] However, the IRS appears to have avoided becoming involved to any significant degree in this type of controversy. The Exempt Organizations Handbook indicates that so long as an organization that educates the public on controversial issues avoids engaging in legislative or political activities characteristic of an "action" organization, it will be able to function without interference from the IRS provided it "stick[s] to the reasoned approach and avoid[s] unsupported opinion."[482]

Ancillary Activities in Furtherance of Education

Incidental Noneducational Activities of an Educational Organization

The IRS recognizes that in order for an educational institution to achieve its educational purposes, it may be required to engage (either directly or through wholly owned subsidiaries) in various activities that are not educational *per se.* Thus, the IRS has stated that "activities which in themselves are not educational or charitable may be incidental to such purposes; and if they are, such activities do not constitute a ground for denying the exemption."[483] Activities that are neither educational *per se* nor directly involved with an educational function but have nevertheless been viewed as incidental to the achievement of an educational purpose in appropriate circumstances include the following: The operation of a cafeteria and gift shop by an art museum for the convenience of its visitors;[484] the operation of a student book store and restaurant on the campus of a university primarily for the convenience of its student body and faculty;[485] the provision of housing and food to students and faculty members of a university;[486] the furnishing by a subsidiary of a 501 (c) (3) educational organization of electric power to its parent organization to enable the parent to carry on its educational activities.[487]

The foregoing enumeration could be extended to include many other noneducational activities which by custom and tradition, or for reasons of convenience or necessity, are carried on by or under the control of an educational institution to facilitate the accomplishment of its educational purposes.

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Noneducational Organizations That Advance Education

Reflecting the general law of charity, the regulations recognize that the advancement of education is an exempt purpose under section 501 (c) (3).[488] Thus, an organization that does not itself directly engage in educational activities may nevertheless qualify under section 501 (c) (3) if its activities are carried on for the purpose of advancing education. A variety of organizations that are not educational *per se* have been accorded exemption under this rationale. A clear example, and perhaps the oldest from a historical standpoint, is a trust that provides financial support for a school or other educational institution but does not itself engage in educational activities.[489] In the same category are university alumni associations, which have been held to be exempt under section 501 (c) (3) on the ground that their primary purpose is to support education, notwithstanding the fact they also engage in incidental recreational and social activities.[490]

Advancement of education may take the form of providing financial support for an ancillary noneducational activity of a university. Thus, the IRS has ruled that an organization that furthers a university's athletic program by subsidizing special eating facilities for members of the athletic teams of the university qualifies under section 501 (c) (3).[491]

Support of education need not be exclusively in the form of gifts of money. Thus, an organization that provides specialized investment services exclusively for colleges and universities at virtually no cost to them is exempt under section 501 (c) (3).[492]

One of the most common means of advancing education is through the support of students. Bogert points out that ". . . the advance of education implies not only teachers capable of giving instruction, but also students able to receive the benefits of the teaching. Consequently trusts which stimulate students to seek an education or aid them in acquiring it are clearly educational. Under this heading fall trusts to establish scholarships for the purpose of paying the tuition and other expenses of students while receiving instruction, trusts to lend money to students, to furnish them with clothing, or housing, or to establish prizes and other awards for excellence in literary or scientific work. [footnotes omitted]"[493]

Consistent with the foregoing authorities, the IRS has recognized the exempt status under section 501 (c) (3) of organizations that aid students through the granting of scholarships[494] and the extension of loans at favorable interest rates.[495] Similarly, the IRS has held that an organization that recognizes and encourages scholastic achievement and leadership also advances education.[496]

It is significant to note that while programs to aid students in obtaining an education are frequently limited to poor children, under the general law of charity ". . . such restriction is not necessary in order to make them charitable. It would seem necessary only that the 'beneficiaries' be persons capable of receiving or transmitting benefits through their education. The financial status of an individual or a class does not determine capacity for improvement by instruction. Society will be aided if any or all of its citizens, rich or poor, obtain wisdom, knowledge, skill, or culture. [footnotes omitted]"[497] Accordingly, the IRS has recognized that a 501 (c) (3) organization may award scholarships on the basis of scholastic ability rather than need.[498]

Limits on the Concept of Advancement of Education Under Section 501 (c) (3)

As the foregoing discussion has shown, a 501 (c) (3) educational institution, such as a school or university, is allowed to engage in a wide variety of activities that are not educational *per se* provided such activities are incidental to the accomplishment of its educational purposes. In addition, an independent organization that is neither owned nor controlled by an educational institution may qualify under section 501 (c) (3) if its purposes and activities advance education. When such an organization provides an educational institution with money, services, or facilities on a gratuitous basis, the benefit to education is clear. However, if the educational institution is required to pay a *quid pro quo* for the services or facilities it receives, a more difficult question is presented. The IRS scrutinizes such cases closely and classifies them according to the following general rules:

1. If the organization in question is a subsidiary of a parent educational institution, and provides services or facilities only to the parent, the subsidiary will be viewed as an integral part of the parent and may qualify under section 501 (c) (3).[499]

2. If the organization in question is owned or controlled by two or more educational institutions to which the organization provides services or facilities on a nongratuitous basis, it may qualify under section 501 (c) (3) if the services or facilities have a sufficiently close relationship to the institutions' educational functions. For example, a membership organization (primarily composed of and supported by schools and colleges) which conducts an accreditation program for educational institutions in a particular geographical region is exempt under section 501 (c) (3) on the ground that its activities "support and advance education by providing significant incentive for maintaining a high quality educational program."[500] A like conclusion was reached with respect to an organization created and controlled by 501 (c) (3) colleges and universities to provide the organizational structure for a regional computer network to enable member educational institutions (including faculty members and students) to benefit from research and scientific information developed by other member institutions and the federal government.[501]

3. The IRS accords different treatment to an organization that provides services or facilities on a nongratuitous basis to a group of educational institutions for use in connection with their administrative functions (such as "class scheduling, billing, or processing applications"[502]) as distinguished from their educational functions. According to the IRS, such an organization does not qualify under section 501 (c) (3). In brief, it would seem that the position of the IRS is that the performance of administrative functions on a nongratuitous basis for two or more 501 (c) (3) organizations constitutes an unrelated trade or business, and if the conduct of such a trade or business is the primary purpose of an organization it cannot qualify under section 501 (c) (3). A more detailed analysis of this subject appears in Chapter VIII of this report, relating to business activities of 501 (c) (3) organizations.

VI

CRITERIA PERTAINING TO SCIENTIFIC ORGANIZATIONS

There was no reference to scientific purposes in the 1601 Statute of Charitable Uses. However, by the time the forerunner of section 501 (c) (3) was enacted in 1913 the advancement of science had long been considered a charitable activity. For example, an 1832 decision of the Supreme Judicial Court of Massachusetts stated: "That a gift designed to promote the public good, by the encouragement of learning science and the useful arts, without any particular reference to the poor, is regarded as a charity, is settled by a series of judicial decisions, and regarded as the settled practice of a court of equity."[503]

It is difficult to identify the precise moment in time that scientific purposes came to be regarded as charitable. This expansion of the concept of charity did not result from any conscious change in judicial thinking but instead seems to have occurred gradually and naturally over many years in recognition of the benefits to society that could be obtained through the advancement of science and technology.

At the same time, however, the courts recognized that not all scientific activity should necessarily be regarded as charitable. A 1909 decision stated the problem as follows:

> [I]nstitutions of learning and science may or may not be charitable, according as the institution is carried on for public benefit alone, or for private gain . . . while it may be true that the encouragement of scientific discovery and inventions might, in a very general way, tend to promote the benefit of mankind and the advance of civilization, yet, in view of the decisions above cited, it cannot be said that these purposes are in themselves necessarily charitable . . . Scientific discoveries might be of such a nature that they would be hurtful and evil in tendency and effect . . . Both scientific discoveries and inventions may be of such a character as to inure entirely to the personal profit of the discoverer or inventor or of other persons interested or affected.[504]

Accordingly, under the general law of charity the courts have traditionally been required to distinguish those activities that are merely scientific from those activities that are scientific and also charitable.

Not surprisingly, this has also been the principal problem in determining the application of section 501 (c) (3) to scientific organizations. Unlike the other areas of exempt activity, which for the most part do not as easily lend themselves to commercial exploitation, scientific research is carried on extensively by organizations in both the business and philanthropic sectors. Moreover, in many cases, in order for the public to benefit from scientific research carried on by the philanthropic sector, the results of the research must be made available to the business sector for use in the production of goods or services which will be sold by the business sector to the public for a profit. The rules developed for dealing with this complex situation are discussed below.

The Meaning of "Scientific"

The IRS has not promulgated a comprehensive definition of the term "scientific." The regulations provide, however, that the term "scientific" as used in section 501 (c) (3) "includes the carrying on of scientific research in the public interest." The regulations further provide:

> Research when taken alone is a word with various meanings; it is not synonymous with "scientific"; and the nature of particular research depends upon the purpose which it serves. For research to be "scientific," within the meaning of section 501 (c) (3), it must be carried on in furtherance of a "scientific" purpose. The determination as to whether research is "scientific" does not depend upon whether such research is classified as "fundamental" or "basic" as contrasted with "applied" or "practical."[505]

The absence of a definition of "scientific" in the regulations does not appear to have given rise to any serious problems in the administration of section 501 (c) (3). The meaning of this term in common usage seems sufficiently well understood to obviate the need for a precise legal definition, and the decision of the IRS to refrain from attempting to formulate such a definition seems to be a sound one.[506] As noted earlier, the principal problem is not to define "scientific," but to delineate the situations in which activities which are admittedly scientific are also sufficiently in the public interest to merit tax exemption under section 501 (c) (3). In dealing with this problem the regulations concentrate primarily upon "scientific research" because this is the area in which the most difficult questions arise.

"Scientific Research" Under Section 501 (c) (3)

The Exclusion of Activities Incidental to Commercial or Industrial Operations

As noted earlier, the regulations make clear that the test of exemption under section 501 (c) (3) does not depend upon whether research is classified as "fundamental" or "basic" as contrasted with "applied" or "practical." Accordingly, depending upon the circumstances, "applied" or "practical" research can qualify as "scientific" for purposes of section 501 (c) (3). However, the regulations also provide: "(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."[507]

This is the only instance in which the regulations specifically classify a particular type of activity as being, in effect, "nonscientific." The scope of the activities that are intended to be excluded from the scientific category by this provision is not entirely clear. It has been suggested that the application of this provision should be limited to activities similar to those referred to in the accompanying examples – namely, "the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."[508] The few published rulings that have been issued under this provision are generally consistent with this interpretation.

In one ruling[509] the IRS relied upon this provision of the regulations in denying exemption to an organization that conducted clinical tests of drugs for commercial pharmaceutical companies in order to comply with Food and Drug Administration requirements that drugs be tested for safety and efficacy before they can be marketed. This ruling states: "Clinical testing is an activity ordinarily carried on as an incident to a pharmaceutical company's commercial operations. The fact that the testing must be done by highly qualified professionals does not change its basic nature. Therefore such testing does not constitute scientific research. . . ."[510]

In another ruling[511] the IRS denied exemption to an organization formed to foster the development of labor-saving agricultural machinery. The organization undertook projects to identify the need for new types of such machinery and then arranged for the development, design, and testing of the machinery. If a machine proved successful, a patent would be sought in the organization's name and a manufacturer would be licensed to build and sell the machine on an exclusive or nonexclusive basis. Any royalties received by the organization were used to develop additional machines. The successful development of such machinery was expected to reduce ultimately the cost of agricultural crops to the public.

In denying the organization exemption under section 501 (c) (3) the IRS stated that ". . . the development or designing of machinery *under the circumstances present in the instant case* is incident to a commercial operation and does not constitute 'scientific research' within the meaning of . . . the regulations. [emphasis added]"[512] This statement implies that in other circumstances the development or design of machinery could constitute scientific research for purposes of section 501 (c) (3), perhaps as a form of "applied" or "practical" research which the regulations specifically indicate can be exempt. Thus, for example, as discussed below, a research organization (such as the one involved in the foregoing ruling) that makes freely available to the public any patents for machinery developed by it through research might qualify as "scientific" for purposes of section 501 (c) (3).[513]

The Requirement That Scientific Research Be in the Public Interest

Since an organization may qualify under section 501 (c) (3) only if it serves a public rather than a private interest, it is necessary to determine when scientific research will be regarded as carried on in the public interest. The regulations contain detailed rules regarding this question. In general, these rules are intended to insure that the benefit from any research performed by a 501(c) (3) organization will be enjoyed primarily by the public and not by a private person (or group).

For purposes of the present discussion these rules may be divided into two categories, namely (1) rules as to when scientific research will be regarded as carried on in the public interest and (2) rules as to when an organization that is engaged in scientific research *will not* be regarded as organized and operated in the public interest.[514]

When scientific research is deemed to be carried on in the public interest. Under the regulations there are three alternative tests for determining whether scientific research will be recognized as carried on in the public interest. The clearest of these pertains to governmental research. The regulations state that scientific research that "is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof..." will be regarded as carried on in the public interest.[515]

The two other alternative tests for determining whether scientific research is carried on in the public interest focus, respectively, upon (1) the manner in which the results of the research are made available to the public and (2) the purpose for which the research is carried on. For convenience, these two tests will be referred to in this discussion as the "results" test and the "purpose" test, respectively.

Under the regulations the "results" test will be satisfied "if the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;..."[516] Accordingly, this test will not be satisfied if the results of the research are made available only on a selective or restrictive basis.[517] However, if the test of nondiscriminatory availability is satisfied, it is not necessary that the results of the research be made available to the public free of charge. Accordingly, in such a case the charging of a nondiscriminatory royalty by the research organization does not preclude the research from being regarded as carried on in the public interest for purposes of section 501(c) (3).[518]

With respect to the so-called "purpose" test, the regulations provide that scientific research will be recognized as carried on in the public interest "if such research is directed toward benefiting the public."[519] The regulations set forth four examples of scientific research that will be deemed to meet this test. The first two examples describe research activities carried on for "educational" purposes, namely: (1) Scientific research carried on for the purpose of aiding in the scientific education of college or university students;[520] (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, trade publication, or in any other form that is available to the interested public.[521]

The third example is scientific research carried on for the purpose of discovering a cure for a disease.[522] Such research is obviously of great benefit to the public and is probably the best illustration of the type of research that the average person would regard as meriting tax exemption.

The fourth example of scientific research which will be considered as directed toward benefiting the public is scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development or retention of an industry in the community or area.[523] Unlike the first three examples mentioned above, wherein the specified research bears a clear relationship to a purpose that is "charitable" under the general law of charity (that is, education, or the cure of disease), the historical rationale for the fourth example is less clear. The example was apparently included in the regulations in order to confirm the exempt status under section 501(c) (3) of certain research institutes which had been established in various parts of the country with a view to promoting the industrial development of their respective regions through scientific research. This provision of the regulations appears to rest upon the premise that industrial development of an area is sufficiently beneficial to the community to justify the grant of tax exemption to scientific research that is carried on for the purpose of achieving this result.

In this connection, it is interesting to note that as an outgrowth of the environmental and conservation movements, a number of "public interest" research organizations have been established to carry on scientific research for the purpose of opposing (through litigation or education of the public) the development of new industry where the research indicates that such development would not be beneficial to the public. Examples of industrial development proposals that have been opposed by public interest research organizations on scientific grounds include proposals involving strip-mining, the development of the SST airplane, and the construction and siting of nuclear plants for the generation of electricity. Since the public interest organizations that carry on this type of research customarily make the results of their research available to the public on a nondiscriminatory basis, such research satisfies the "results" test. In addition, it would seem to satisfy the "purpose" test because it is directed toward benefiting the public, notwithstanding that it is not specifically mentioned in the examples set forth in the regulations.[524] It is not unusual for organizations with opposing points of view regarding controversial public issues to qualify for exemption under section 501(c) (3).[525]

The regulations provide that scientific research that satisfies the "purpose" test (by being "directed toward benefiting the public") will be regarded as carried on in the public interest even though the sponsor of the research has the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.[526] Thus, for example, if a 501(c) (3) organization performs scientific research sponsored by a pharmaceutical company for the purpose of discovering a cure for a disease, it is permissible for the contract pursuant to which the research is performed to provide that the pharmaceutical company shall be entitled to obtain the ownership of any patents, processes, or formulae resulting from the research. The same would be true of scientific research sponsored by a business corporation for the purpose of attracting new industry to a geographical area, as, for example, by developing a new process for the industrial use of natural resources that are in abundant supply in the area.

In such cases the research results, by hypothesis, would not be made available to the public on a nondiscriminatory basis because they would be owned by the business corporation which sponsored the research. Thus, the research could not qualify as having been carried on in the public interest under the "results" test. However, in view of the benefit to the public which the regulations presume to flow from scientific research that qualifies under the "purpose" test, such research can be carried on by a 501(c) (3) organization even though a substantial private economic benefit is realized therefrom by the sponsor of the research. The rationale of this provision of the regulations appears to be that the private benefit realized by the sponsor is incidental to the greater benefit that the public is presumed to derive from the research. A similar weighing of public and private benefits occurs in other situations under section 501(c) (3), and the principle is well established that an "incidental" private benefit will not prevent an otherwise exempt activity from qualifying under section 501(c) (3).[527]

When an organization engaged in scientific research will not be regarded as organized and operated in the public interest. The regulations set forth two situations in which an organization that carries on scientific research will not be regarded as organized and operated in the public interest and consequently will not qualify as a "scientific" organization under section 501(c) (3).

The first is when the organization will perform research only for persons that are (directly or indirectly) its creators and that are not described in section 501(c) (3).[528] In such a situation, it appears to be immaterial that the results of the research are made available to the public on a nondiscriminatory basis, or even free of charge. Although in that case the "results" test would be ostensibly satisfied, the research organization cannot qualify under section 501(c) (3) because it is a "captive" of its creators and is therefore presumed to be organized and operated primarily to serve their private interests and not the public interest.[529]

The second situation described in the regulations in which a research organization will not be regarded as organized and operated in the public interest is where it retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make them available to the public.[530] Thus, for example, if the research results are kept secret by the research organization and are not communicated to anyone else, the public cannot derive any benefit from the research and the organization does not merit exemption under section 501(c) (3). However, if the research organization retains ownership or control of the research results but makes them available to the public on a nondiscriminatory basis (not necessarily free of chage), the organization will not be disqualified under this provision of the regulations.

In addition, the regulations recognize that in some situations a public benefit from scientific research is not necessarily achieved merely by making the research results available to the public on a nondiscriminatory basis. For example, assume that a 501(c) (3) research organization discovers a new vaccine for the cure of a disease, and obtains a patent therefor. If the vaccine is very costly to manufacture, requiring the expenditure of substantial capital funds to build the necessary facilities, it is possible that no business corporation would be willing to make the necessary investment in such facilities unless it could obtain the exclusive right to the use of the patent. In such a case, the regulations provide that "if the granting of such exclusive right is the only practicable manner in which the patent [or other research results] can be utilized for the benefit of the public," it will be permissible for the 501(c)(3) research organization to grant such an exlusive right. However, this liberal rule is limited to situations in which the research that produced the patent (or other research results) qualifies under either the governmental test or the "purpose" test of the regulations. That is, the research must be carried on either (1) for the United States, or any of its agencies or instrumentalities, or for a state or political subdivision thereof, or (2) for a purpose that the regulations regard as "directed toward benefiting the public"[531] as discussed above.

The Scope of Scientific Activity Under Section 501(c) (3)

There is very little authority regarding the subject matter that may fall within the scope of scientific activity under section 501(c) (3) It is clear that scientific research under section 501(c) (3) encompasses research in the social sciences[532] as well as the physical sciences. As is true in the case of education,[533] it would seem that insofar as subject matter is concerned the boundaries of scientific activity are limited only by the bounds of knowledge itself. So long as the requirements of law and public policy are satisfied, there would seem to be no reason to impose limits upon the range of topics that may be subjected to scientific inquiry for purposes of section 501(c) (3).[534]

In addition, it would seem that wide latitude should be allowed in regard to the methods of research that may be employed by a scientific organization. In one interesting unpublished ruling, the IRS held that the operation of a pilot project for providing prepaid legal services qualified as scientific research under section 501(c) (3) where the purpose of the project was to obtain actuarial and other information regarding the feasibility of such a program and to analyze and distribute that information to interested members of the legal profession and the general public.[535]

Dissemination of the results of scientific research is, of course, a necessary step in the process whereby such research is utilized for the benefit of the public. Thus, organizations that do not carry on scientific research themselves but, rather, abstract and disseminate the newest scientific advances made by others have been granted exemption under section 501(c) (3) as scientific and educational organizations.[536]

Scientific Research and the Unrelated Business Income Tax

Although a detailed discussion of the unrelated business income tax provisions of the Code is beyond the scope of this report, it may be noted that three of these provisions pertain to the conduct of scientific research by 501(c) (3) organizations.

Governmental Research

Section 512(b) (7) provides that in computing unrelated business taxable income there shall be excluded all income derived from research for the United States or any of its agencies or instrumentalities, or any state or political subdivision thereof. This means that any profit derived by a 501(c) (3) organization from the performance of such governmental research will not be subject to unrelated business income tax. In addition, as previously discussed, the regulations under section 501(c) (3) go a step further and characterize such research as being in the public interest *per se* for purposes of section 501(c) (3). Thus, an organization that is exclusively engaged in performing scientific research for federal and state governments would be exempt from income tax under section 501(c) (3) and would also be exempt from the tax on unrelated trade or business income by reason of section 512(b) (7).

Research Activities of 501(c) (3) Colleges, Universities, Hospitals, and Organizations Engaged Primarily in Carrying on Fundamental Research

Section 512(b) (8) provides that in the case of a college, university, or hospital there shall be excluded all income derived from research performed for any person. Section 512(b) (9) provides similar treatment with respect to organizations operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research), the results of which are freely available to the general public. This means, in effect, that a 501(c) (3) organization of the type described in those sections has been given the benefit of a statutory presumption that all of its research work is related to its exempt functions, for purposes of the tax on unrelated business income.

VII

OTHER EXEMPT PURPOSES: PREVENTION OF CRUELTY TO CHILDREN OR ANIMALS, LITERARY, AND TESTING FOR THE PUBLIC SAFETY

The tax exemption granted to 501(c) (3) organizations extends to those organized and operated exclusively for prevention of cruelty to children or animals, literary purposes, and testing for public safety. The paucity of court decisions and revenue rulings with respect to organizations formed for these purposes would seem to indicate that they are not frequently used as a basis for exemption under section 501(c) (3).

Prevention of Cruelty to Children

The "prevention of cruelty to children" was added to the list of exempt purposes by the Revenue Act of 1918.[537] While the legislative history is silent as to exactly what prompted the 1918 amendment, it seems likely that the amendment was intended to provide encouragement to organizations whose efforts were devoted to preventing the unlawful use of child labor.

During much of the Industrial Revolution the employment of children in unsanitary and hazardous working conditions was commonplace, but by 1918 it was widely accepted that this practice was detrimental to the general welfare. The prevailing viewpoint was expressed by Mr. Justice Day in *Hammer* v. *Dagenhart*,[538] decided in 1918:

> That there should be limitations upon the right to employ children in mines and factories in the interest of their own and the public welfare, all will admit. That such employment is generally deemed to require regulation is shown by the fact that the brief of counsel states that every State in the Union has a law upon the subject, limiting the right to thus employ children.[539]

Accordingly, the strong social interest in protecting children from hazardous employment and other abuses could have provided the impetus for the addition of "prevention of cruelty to children" to the list of exempt purposes in the statute. It may be noted, however, that this addition may not have significantly enlarged the scope of the statute, because the prevention of cruelty to children is recognized as a charitable purpose under the general law of charity.[540]

There appears to have been only one published ruling in which "prevention of cruelty to children" was relied upon by the IRS as a separate ground for granting exemption under section 501(c) (3). This ruling recognized the exempt status of an organization formed for the purpose of preventing children from working in hazardous trades in violation of state laws.[541]

Prevention of Cruelty to Animals

The "prevention of cruelty to animals" was also added to the list of exempt purposes by the Revenue Act of 1918.[542] As in the case of the prevention of cruelty to children, the added language may have been surplusage because the prevention of cruelty to animals and has also been recognized as a charitable purpose under the general law of charity.[543]

In recent years, income tax exemption has been granted under section 501(c) (3) to organizations engaged in diverse projects for the benefit of animals, such as the conduct of a voluntary accreditation program for laboratory animal care facilities[544] and the provision of funds for spaying or neutering pets to prevent the birth of unwanted animals.[545] However, exemption under section 501(c) (3) was denied to a dog club formed to promote the ownership and training of purebred dogs because it was operated primarily for the benefit, pleasure, and recreation of its members.[546]

An organization that operated a community pound for the care, protection, placement, and humane disposal of stray animals was denied exemption under section 501(c) (3) because it also attempted to influence legislation that it considered to be for the benefit of animals and animal lovers.[547]

Literary Purposes

Income tax exemption was extended to "literary" organizations by the Revenue Act of 1921,[548] under a predecessor of section 501(c) (3). The legislative history is silent as to the reason for this addition. Literary purposes are not defined by statute or regulations, and the absence of any relevant authority in the form of rulings or case law would tend to indicate, as several commentators have suggested, that organizations that carry on literary programs must qualify as educational, charitable, scientific, or religious in order to obtain exemption under section 501(c) (3).[549]

A problem often faced by "literary" organizations that seek to qualify under section 501(c) (3) is to distinguish themselves from a commercial publishing operation. An indication of the criteria that the IRS applies in such cases is provided by Revenue Ruling 67-4,[550] in which the IRS stated:

> An organization engaged in publishing scientific and medical literature may qualify for exemption from Federal income tax under section 501(c) (3) of the Code if (1) the content of the publication is education, (2) the preparation of material follows methods generally accepted as 'educational' in character, (3) the distribution of the materials is necessary or valuable in achieving the organi-

zation's educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

The organization involved in Revenue Ruling 67-4 was held to satisfy the foregoing requirements and therefore to qualify under section 501 (c) (3) as an educational and scientific organization. The possible "literary" rationale for granting the organization exemption was not mentioned. The same was true of a ruling involving an organization that prepared and distributed abstracts of scientific and medical literature.[551] In these two rulings the distribution of the publications was accomplished either free of charge[552] or at a charge below cost.[553] This factor appears to have been significant in the conclusion of the IRS that the organizations were distinguishable from ordinary commercial publishing operations.

In contrast to these situations, a nonprofit corporation that published a foreign language magazine containing fiction, poetry, book reviews, and articles of a literary, scientific, and educational character in order to provide a vehicle for the creative activity of writers and scholars emigrating from a foreign country was denied exemption because the manner of publication and sale of the magazine, which was available to the general public through regular paid subscriptions, was not distinguishable from ordinary commercial publishing practices.[554] Similarly, a nonprofit organization created to meet the need for more satisfactory college teaching materials and textbooks in economics and related fields by sponsoring the preparation of such materials was denied exemption because it shared the royalties from sales of the published materials with the authors. For this reason, the IRS treated the organization as one conducted in an essentially commercial manner.[555]

Testing for Public Safety

The final purpose for which a 501 (c) (3) organization may be organized and operated is "testing for public safety." This is the only purpose enumerated in section 501 (c) (3) that is not also listed in the "charitable deduction" sections of the Code. Accordingly, although organizations engaged exclusively in testing for public safety are exempt from income tax under section 501 (c) (3), contributions to such organizations are not deductible for income, gift, or estate tax purposes.[556]

Prior to 1954, the Internal Revenue Code did not specifically exempt organizations engaged in testing for public safety, and therefore such an organization could qualify under the predecessor of section 501 (c) (3) only by meeting the criteria that applied to charitable, scientific, or educational organizations. In the leading case to be decided with respect to this issue under prior law, exemption was denied to an organization sponsored by an association of fire insurance companies that conducted experiments and investigations into the causes of fires and the resistance to hazards of various manufactured electrical products.[557] The organization also provided a testing service to manufacturers to determine if their products met standards developed by the organization, and its income was derived primarily from fees paid by the manufacturers who used this service. In denying the organization exemption, the court held that the primary purpose of the organization was to serve the business interest of the insurance companies and manufacturers and that any benefit inuring to the public was merely incidental.

This decision was in effect overruled by Congress in 1954 by the reference in section 501 (c) (3) to organizations engaged in testing for public safety.[558] The regulations specifically define the term "testing for public safety" to include "the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public."[559] Under this provision exemption has also been granted to a membership organization formed by a group of marine underwriting companies and boat manufacturers for the purpose of inspecting, evaluating, and testing for safety products intended for use in the manufacture of small pleasure boats.[560]

By its very nature, the testing of consumer products for public safety will ordinarily confer a benefit not only upon the public, but also upon the manufacturers whose products are tested. In deciding to include testing for public safety as an exempt purpose under section 501 (c) (3), Congress in effect determined that for purposes of granting tax exemption, the benefit to the public is sufficiently great to outweigh the private benefit to the manufacturers. However, the IRS has taken the position that this does not apply where the testing is intended to meet Food and Drug Administration requirements that drugs be tested for safety and efficacy before they can be marketed.[561] The reasoning of the IRS in support of this position is that since a drug is not a "consumer product" available for use by the public until it is approved for marketing by the FDA, the testing of a drug for the purpose of obtaining such approval serves primarily the interest of the manufacturer rather than the public and thus is not exempt.

It is interesting to note that the IRS has specifically ruled that a "public testing" organization can qualify for exemption under section 501 (c) (3) even though it is supported entirely by charges paid by manufacturers who make use of its testing facilities and services.[562]

VIII

BUSINESS ACTIVITIES OF 501 (c) (3) ORGANIZATIONS

A question that frequently arises in connection with the administration of section 501 (c) (3) is the extent to which a 501 (c) (3) organization may engage in income-producing activities and still maintain its tax-exempt status. It is a problem inherent in the statute itself, since the granting of income tax exemption to specified categories of organizations constitutes an implied acknowledgment that they may have income that would be subject to tax in the absence of such exemption.

The problem generally arises when a 501 (c) (3) organization derives income from the conduct of business activities similar to those ordinarily carried on by commercial enterprises for profit.[563] Rules have been developed for determining when activities of this type are of such a nature and magnitude as to result in either (1) loss of exemption by the organization that carries on the activity, or (2) taxation of the income derived from the activity (without loss of exemption by the organization). These rules will now be examined, beginning with their legislative and judicial history. Because this report is concerned primarily with the criteria for exemption under section 501 (c) (3), the following discussion will focus mainly on the first of these two aspects of business activities of 501 (c) (3) organizations, namely, the circumstances under which such activities will result in loss of tax exemption. A detailed discussion of the rules relating to taxable business activities of 501 (c) (3) organizations (the tax on unrelated trade or business income) is beyond the scope of this report.

Historical Background of the Rules Relating to Business Activity

Prior to the Revenue Act of 1950, the business activities of exempt organizations were governed by rules of judicial rather than legislative or administrative creation. In 1924, in its opinion in *Trinidad* v. *Sagrada Orden*,[564] the Supreme Court stated with respect to a statutory predecessor to section 501 (c) (3): "First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test for exemption."[565] With this language the Supreme Court created the "destination of income" test under which an organization would be treated as organized and operated exclusively for exempt purposes if its income was applied to charitable or other exempt purposes.

By 1950 the courts were unanimously of the view that organizations engaging directly in substantial charitable, educational, religious, or other exempt activities were exempt from tax as to the whole of their income, notwithstanding the fact that they also carried on profitable business activities that were not related to their exempt purposes.[566] In addition, by 1950 the "destination of income" test had been extended by a majority of courts to "feeder organizations," that is, those engaged exclusively in business activities but required to distribute their income to other organizations that were admittedly exempt under section 501 (c) (3).[567]

The legal atmosphere was changed by the Revenue Act of 1950. In an effort to create more specific rules to deal with the tremendous growth in the number and activities of exempt organizations after World War II,[568] Congress enacted a group of new Code provisions. For purposes of this discussion, the most important effects of the 1950 act were (1) to subject to tax the income derived by exempt organizations from business activities that were not related to their exempt purposes,[569] and (2) to deny exemption to feeder organizations.[570]

These provisions were intended primarily to solve the problem of unfair competition which had arisen under prior law because charitable and other exempt organizations were permitted to engage in business activities in competition with private economic enterprise without being subject to income tax on the profits derived from such activities.[571] As stated in the Senate Finance Committee's report on the act:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section 101 [predecessor to section 501] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings – a procedure which usually could not be followed if the business were taxable.
>
> In neither the House bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. . . .[572]

Concept of Unrelated Business Activity

As indicated in the preceding discussion, the general approach of the 1950 act was to tax the unrelated business income of exempt organizations to the same extent as the income earned by their nonexempt competitors. It was not intended that the tax imposed on unrelated business income would have any effect on an organization's tax-exempt status.[573]

The tax is imposed by section 511 on the "unrelated business taxable income" of all 501 (c) (3) organizations,[574] that is, the net income derived by any such organization from any unrelated trade or business regularly carried on by it.[575] Section 513 defines an unrelated trade or business[576] as ". . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. . . ."

Thus, three distinct questions must be answered affirmatively before a 501 (c) (3) organization will be found to be carrying on an unrelated trade or business whose income is subject to tax. First, does the activity constitute the conduct of a trade or business? Second, is the trade or business regularly carried on? Third, is the conduct of such trade or business substantially related to the organization's performance of its exempt functions?

With respect to the first test, the statute defines the term "trade or business" to include any activity that is carried on for the production of income from the sale of goods or performance of services.[577] The regulations suggest that this test is applied in light of the primary objective of the unrelated business income tax "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[578] Accordingly, if a 501 (c) (3) organization conducts an activity that competes with commercial business entities, the activity will usually be regarded as a trade or business.[579]

It is important to note that an activity may constitute a trade or business even though it is conducted as an integral part of other activities of an exempt organization.[580] The regulations state that

> . . . the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes . . .[581]

Thus, an activity that would not be carried on except in conjunction with the exempt activities of a 501 (c) (3) organization may nevertheless constitute an unrelated trade or business. For example, the sale and publication of commercial advertising may generate unrelated business taxable income even though the advertising appears in a journal that is published by, and clearly related to the exempt purposes of, a 501 (c) (3) organization.[582]

Once it has been determined that an activity constitutes a trade or business, consideration must be given to whether it is "regularly carried on." The regulations direct that this requirement also be applied in light of the tax's purpose to place business activities of exempt organizations upon the same tax basis as those of their nonexempt competitors. The regulations provide: ". . . specific business activities of an exempt organization will ordinarily be deemed to be 'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable activities of nonexempt organizations."[583]

As the language in the regulations implies, a trade or business is "regularly carried on" when it is conducted over the same general time span as that of comparable private businesses. Thus, the conduct for several weeks by an exempt organization of a business that would normally be conducted on a year-round basis by a commercial enterprise will not be treated as regularly carried on. However, if the business would normally be conducted only seasonally, its conduct by an exempt organization during a substantial portion of the season would constitute the regular carrying on of the business.[584] Taking the comparison one step further, intermittently conducted activities will not be considered to be regularly carried on if they are conducted without the competitive and promotional efforts typical of comparable commercial endeavors.[585]

After it has been determined that a 501 (c) (3) organization is regularly carrying on a trade or business, the final inquiry is whether the conduct of the trade or business is substantially related to the purposes for which the organization was granted exemption. To answer this question it is necessary to examine the relationship between the business activities of the organization and the accomplishment of its exempt purposes.[586] Thus, the regulations provide:

> Trade or business is 'related' to exempt purposes... only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is 'substantially related,' for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes....
>
> Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.[587]

In essence, the regulations require that the business activities have a "causal" and "substantial" relationship with, and "contribute importantly" to, the accomplishment of the organization's exempt purposes if the activities and the exempt purposes are to be treated as substantially related.[588] The application of such a test will generally require a factual analysis in each case. Thus, for example, income derived from charges for the conduct of exempt functions, as in the case of admission charges to performances by students of a dancing school, is not income from an unrelated trade or business.[589] Similarly, income derived from the sale of products made by handicapped persons as part of a rehabilitation program would not constitute income from the conduct of an unrelated trade or business, provided the products are sold in substantially the same state they are in upon completion of the exempt function.[590] In both examples, the activity generating the income contributes substantially to the accomplishment of the exempt functions—the training of students to perform before audiences and the rehabilitation of the handicapped.

One of the factors that must be considered in determining whether business activities contribute importantly to the accomplishment of an exempt purpose is the relationship between the size and extent of the business activities and the nature and extent of the exempt function they purport to serve. Where the activities are in part related to the performance of exempt functions but are conducted on a scale larger than reasonably necessary for the performance of such functions, the income attributable to the excess activities is treated as unrelated business income.[591]

Whether or not a particular business activity will be deemed to contribute importantly to the accomplishment of an organization's exempt purposes is a question of degree.[592] There are several rulings that indicate that the IRS takes a pragmatic approach in resolving this question. One example, Revenue Ruling 69-267,[593] considered a hospital's operation of a gift shop which sold candy, newspapers, magazines, flowers, and other small gift items and was patronized by patients, visitors making purchases for patients, and hospital employees. The ruling concluded that by facilitating the purchase of merchandise and services "to improve the physical comfort and mental well-being of its patients," the hospital's gift shop encouraged the patients' recovery and therefore contributed importantly to the hospital's exempt purpose of providing health care for members of the community.[594]

Similarly, Revenue Ruling 73-104[595] considered the case of a museum of modern art which sold greeting cards displaying printed reproductions of selected works of art at a shop in the museum, by mail order, and to retail stores. The sale of cards was promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers. The IRS ruled that the sale of the cards contributed importantly to the achievement of the museum's educational purposes because it stimulated the public's awareness and appreciation of art and encouraged the public to visit the museum.

In other situations the necessary degree of relationship has been found not to exist. Thus, for example, in Revenue Ruling 73-105[596] the IRS considered the operation of a souvenir shop by an exempt folk art museum. The sale of art history books, reproductions of paintings, and other works of art was found to enhance the public's appreciation of art and thus contribute importantly to the accomplishment of the museum's exempt purposes. However, its sale of scientific books and souvenirs of the city in which the museum was located was found to bear no causal relationship to the accomplishment of the museum's exempt purposes and therefore was held to be an unrelated trade or business.[597]

In addition to its role in determining whether a 501(c) (3) organization will be taxed on income derived from business activities, the concept of an unrelated trade or business can also be significant in determining whether an organization is entitled to tax exemption at all. However, the operative rules for determining when the tax-exempt status of a 501(c) (3) organization will be adversely affected by the organization's conduct of unrelated trade or business activities are not entirely clear. The regulations pertaining to the "organizational test" could be interpreted as authorizing a 501(c) (3) organization to engage in no more than an "insubstantial" amount of unrelated business activity, since these regulations require that the articles of organization ". . .not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."[598]

The regulations pertaining to the "operational test" contain both a "primary activity" test and an "insubstantial activity" test, providing in part as follows:

> (1) *Primary activities*. An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c) (3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[599]

Finally, in another paragraph of the regulations under section 501(c) (3) it is provided that exemption will be denied if an organization is "organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513" of the Code[600]

Under the foregoing provisions of the regulations, it would appear that (1) exemption under section 501(c) (3) will not be adversely affected by the conduct of an unrelated trade or business as an insubstantial part of an organization's overall activities, but (2) exemption will be lost if the conduct of an unrelated trade or business is so substantial in relation to the organization's overall activities as to constitute the primary purpose or activity of the organization.[601] However, it is not clear to what extent an organization's 501(c) (3) status will be endangered if its unrelated trade or business activities constitute more than an insubstantial part of its overall activities, but not such a large part as to represent its primary purpose or activity. The regulations under the "operational test," quoted above, might be construed as meaning that an organization would not qualify for exemption under section 501(c) (3) in such a case. However, this result seems difficult to reconcile with the emphasis in the regulations upon the "primary purpose" of the organization, and also with the legislative history of the 1950 act, which indicates that Congress intended to deal with the problem of unrelated business activities of otherwise exempt organizations merely by imposing an income tax on the net income arising from such activities and not by denying tax exemption to such organizations.[602]

Denial of Exemption to Feeder Organizations

In addition to imposing an income tax on the unrelated business income of most 501 (c) (3) organizations, the Revenue Act of 1950 took the further step of removing the tax-exempt status previously available to "feeder organizations" under the "destination of income" test. This provision is now found in section 502, which states:

> (a) General Rule – An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

Section 502 is concerned only with an organization's operation, not its organization, and is brought into play only when the "primary purpose" of that operation is the conduct of "a trade or business for profit."[603] Its application is limited by its terms to an organization that would (absent section 502) base its claim for exemption solely on the ground that it "feeds" all its income to exempt organizations.[604]

Because of its limited applicability, few problems of interpretation have arisen under section 502. One potential ambiguity has been resolved by the regulations, that is, the problem of distinguishing between (1) a feeder organization which is engaged in business for profit, and (2) a subsidiary of an exempt organization that is merely carrying on an integral part of the exempt activities of its parent.[605] In this regard the regulations provide:

> If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization . . .[606]

The foregoing rule is consistent with the principles that underlie the unrelated business income tax. If income derived from the conduct of a trade or business would be exempt from tax under section 511 because the trade or business is substantially related to the exempt purposes of the sponsoring organization, then income derived from the same trade or business should not be subjected to tax merely because, as a matter of convenience, it is conducted by a subsidiary for the benefit of its 501 (c) (3) parent organization.[607]

There are a number of exceptions to the applicability of section 502 which correspond to the exceptions to the unrelated business income tax. Thus, in general, exemption will not be denied under section 502 to an organization operated for the primary purpose of (1) deriving rents which would not be treated as unrelated business income,[608] (2) carrying on a trade or business in which substantially all the work is performed for the organization without compensation,[609] and (3) carrying on any trade or business which is the selling of merchandise, substantially all of which has been donated to the organization.[610]

Cooperative Service Organizations

One recurring problem which has not been satisfactorily resolved concerns the ability of a group of 501 (c) (3) organizations to "confer" their exempt status upon a separately incorporated organization which performs an essential service exclusively for the 501 (c) (3) organizations in the sponsoring group. The IRS has answered this question in the negative, taking the position that the performance of services for more than a single parent organization is deemed to constitute the carrying on of an unrelated trade or business.[611]

This position was demonstrated in Revenue Ruling 54-305[612] where exemption was denied to an organization organized and operated to maintain a central purchasing agency to establish uniform standards and to purchase supplies for the exclusive benefit of its member hospitals, all of which were 501 (c) (3) organizations. This result was rejected by the Court of Claims in *Hospital Bureau of Standards & Supplies, Inc.* v. *U.S.*,[613] which held such an organization to be exempt. According to the court, the function performed by the organization was "necessary and indispensable" to the operations of the member hospitals and, accordingly, constituted an integral part of such operations. The court further found that the organization was not subject to tax as a "feeder organization" because it was not operated for the primary purpose of carrying on a trade or business for profit. "At most, the [service organization] was performing a function which each of its member hospitals would have to assume were it not for the [service organization's] existence."[614]

In 1968 Congress attempted to resolve the conflict between the IRS and the Court of Claims with respect to cooperative service organizations formed by 501 (c) (3) hospitals by enacting section 501 (e).[615] That section provides that certain hospital service organizations will be treated as organized and operated exclusively for charitable purposes under section 501 (c) (3). However, section 501 (e) is limited to entities organized and operated on a cooperative basis solely to perform the services enumerated in section 501 (e), namely data processing, purchasing, warehousing, billing and collection, food, industrial engineering, laboratory, printing communications, record center and personnel services for 501 (c) (3) hospitals.[616] In addition, all net earnings must be allocated or paid to members on the basis of services performed for them.[617]

The IRS has sought to restrict the application of section 501 (e). In two rulings published in 1969,[618] the IRS ruled that a cooperative hospital service organization, all of whose members are 501 (c) (3) hospitals, will be treated as exempt under sections 501 (e) and 501 (c) (3) only if the organization provides no services other than those specifically enumerated in section 501 (e). Since laundry services are not so enumerated, the IRS ruled that a cooperative hospital service organization will not be exempt if, in addition to data processing and group purchasing services, it also provides laundry services[619] for its members.

The IRS position has been rejected by a federal district court in *United Hospital Services, Inc.* v. *U.S.*,[620] where a service organization, created by several 501 (c) (3) hospitals to maintain and operate a laundry facility for their benefit, was held to be exempt under section 501 (c) (3). In reaching its decision, the court conceded that Congress had intentionally omitted ordinary, general, and commercial laundry services from the blanket exemption granted to cooperative hospital service organizations by section 501 (e) but found that the organization was a charitable organization and exempt from tax under section 501 (c) (3) without reference to section 501 (e). In support of this conclusion the court noted the necessity of laundry and linen services to the accomplishment of the member hospitals' charitable purposes, the inability of commercial laundries to provide such services because of the large quantities of laundry involve, the necessity for sanitary and quality standards which could only be met by special facilities, and the substantial monetary savings inuring to member hospitals. The court also specifically rejected the portion of Regulation §1.502-1 (b) which denies exemption to organizations owned by, and providing services to, more than one exempt organization, as follows:

> . . . the Court has difficulty in finding any basis in the statute, 26 U.S.C. §502, for the underlined portion of the regulation. The statute provides quite simply that "[a] n organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section

> 501 from taxation.' What does this have to do with two or more such organizations setting up a not-for-profit corporation wholly controlled by them, and not serving the public, in order to effect economies in their own charitable operations? The Court in *Hospital Bureau, supra*, gave no effect to the regulation, nor does this Court.[621]

The government has announced that it will not appeal the *United Hospital Services* decision,[622] but has given no indication that its restrictive position with respect to cooperative hospital service corporations will be modified.

Hospitals are not unique among 501(c) (3) organizations in their need to utilize cooperative service organizations as a vehicle for realizing substantial cost reductions and for conducting their operations more efficiently. Educational organizations have also successfully utilized cooperative entities to accomplish these goals. As in the case of hospital service organizations, the IRS' position with respect to the tax-exempt status of such cooperative ventures has generally been restrictive.

The IRS made a limited exception to this policy in 1970, when it granted exemption to the Common Fund, an entity organized by a group of educational institutions to provide a cooperative investment fund that could contract with professional advisors for research, advice, and investment management of the institutions' contributions to the fund.[623] The ruling provided that the fund would retain its exempt status only so long as its investment services were provided to members at a charge substantially below cost, thereby effectively requiring that the fund receive support from outside sources, either in the form of grants or through income from an endowment fund.[624]

It would appear from this ruling that, in the eyes of the IRS, the provision of services at cost by a nonprofit cooperative service organization solely to 501(c) (3) organizations is not sufficient to characterize the service organization as exempt under section 501(c) (3).[625] Congress rejected this narrow view insofar as it applied to the Common Fund by enacting section 501(f) in 1974. This legislative enactment was prompted by the fact that the start-up grants that the Common Fund had received during its formative years had terminated, and the fund was in danger of losing its exempt status because it was no longer able to provide services to its member institutions for a fee "substanitally below cost" as required by the IRS as a condition for exemption.[626] To deal with this specific situation, Congress provided in section 501(f) that an organization would be treated as exempt under section 501(c) (3) if it was (1) comprised solely of members that are tax-exempt educational institutions,[627] (2) organized and controlled by one or more such members, and (3) organized and operated solely for the collective investment of money contributed by members and the payment of all of the income, less expenses, to members.[628]

The legislative history of section 501(f) makes clear that Congress did not intend the enactment of section 501(f) to have any effect upon the question of the exempt status of other cooperative service entities formed by 501(c) (3) organizations. In this regard the Senate Report states: "This amendment is to apply with respect to taxable years ending on or after January 1, 1974. However, it is not intended to imply tht such a cooperative investing organization would not be exempt for prior years. Also, in adding this provision relating specifically to cooperative investment funds, it is not intended that any inference be drawn as to the exempt status of other organizations formed by educational institutions or by other charities on their behalf to carry out their normal functions in a cooperative manner."[629]

In view of the limited scope of sections 501(e) and (f), uncertainty still exists as to whether other cooperative entities formed by 501(c) (3) organizations to meet their needs for specialized services will be able to qualify under section 501(c) (3). In this connection, it should be noted that the IRS has granted exemption to a nonprofit organization formed by a group of accredited educational institutions to develop and publish accreditation standards and to identify and disseminate lists of schools and colleges meeting such standards.[630] Similarly, exemption has been granted to an organization created and controlled by a group of colleges and universities to devise and operate an organizational structure for a regional computer network which would enable member institutions, their faculty and students, to make use of scientific and educational information developed by other members of the organization and the U.S. government.[631]

In both of the foregoing rulings, the services provided were closely associated with the educational functions of the sponsoring organizations,[632] and the IRS therefore concluded that such services qualified under section 501(c) (3) because they had the effect of advancing education. The IRS was careful to point out in the latter ruling that the computer network was neither designed nor used to accomplish administrative functions such as class scheduling, billing, or processing applications. The implication of the ruling is that a computer network that provides such administrative functions would not qualify under section 501(c) (3).

The IRS has thus far failed to articulate any compelling reasons for denying exemption to an organization formed and controlled on a cooperative basis by a group of 501(c) (3) organizations to provide themselves with specialized administrative services for which they have a common need. As noted earlier, the IRS has relied primarily upon the argument that under Regulation §1.502-1(b) such an organization cannot qualify for exemption because its service activities (not being limited to a single parent organization) would constitute "an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations." However, as found by the district court in *United Hospital Services*,[633] there does not appear to be any statutory basis for this result in section 502. That section applies only to an organization operated for the primary purpose of carrying on a trade or business for profit. If a cooperative service organization provides services to its members at cost, then it cannot be said to be conducting a business for profit. In addition, the provision of services on a cooperative basis exclusively to 501(c) (3) organizations would not seem to be the type of unfair competition with commercial enterprise that sections 502 and 511 were intended to prevent.

As discussed previously, the restrictive position of the IRS has been rejected by the courts, and also by Congress to the extent provided in sections 501(e) and (f). In view of the benefits in efficiency of operation and reduced costs that many 501(c) (3) organizations could achieve through the use of cooperative service organizations, it would seem desirable for the 501(c) (3) status of such organizations to be recognized either by a change in the position of the IRS or by the enactment of a more comprehensive statutory solution to the problem.

Footnotes

1. Report of the Committee on the Law and Practice Relating to Charitable Trusts (London: Government publication, 1952), p. 7.

2. F. Emerson Andrews, *Philanthropic Giving* (New York: Russell Sage Foundation 1950), pp. 28-29.

3. Ibid., p. 1.

4. Gareth Jones, *History of the Law of Charity 1532-1827*, (London: Cambridge University Press, 1969), pp. 3-4.

5. See Henry A. Moe, "Notes on the Origin of Philanthropy in Christendom," 105 *Proc. Phil. Soc.*, 141 (1961); W.K. Jordan, *Philanthropy in England 1480-1660* (New York: Russell Sage Foundation, 1959), p. 200.

6. Moe, "'The Vision of Piers the Plowman' and the Law of Foundations," 102 *Proc. Phil. Soc. No. 4*, 372 (1958).

7. Ibid., p. 373.

8. Modern English version of the "B" text, published in *The Vision of William concerning Piers the Plowman in three parallel texts by William Langland.* Edited from numerous manuscripts by the Rev. Walter W. Skeat, 1:228, Oxford, 1886.

9. Jordan, op. cit., generally p. 112.

10. George G. Bogert and George T. Bogert, *Trusts and Trustees,* §321, at 638 f.n.2 (2d ed.) (Kansas City, Mo.: Vernon Law Book Co., 1965).

11. Jones, op. cit., p. 57

12. Ibid.

13. Ibid., p. 27

14. Jordan, op. cit., p. 126.

15. Ibid., pp. 126-27.

16. Report of the Committee, op. cit., p. 8.

17. Ibid.

18. Jones, op. cit., pp. 110-11.

19. Ibid., pp. 107-8.

20. Ibid.

21. 9 Ves. 399 (1804), 10 Ves. 522 (1805); See, Jones, op. cit., pp. 122-7.

22. 22 Q.B.D. 296 (1891); A.C. 531 (1891); Quoted in Report of the Committee, op. cit., p. 31.

23. Lord Sterndale, M.R., *Re Tetley,* 1 ch. 258, 266, (1923), quoted in George W. Keeton, *The Modern Law of Charities,* (London: Sir Isaac Pitman & Sons Ltd., 1962), pp. 26-27.

24. Ibid., p. vi.

25. Report of the Committee, op. cit., p. 1.

26. David Owen, *English Philanthropy 1660-1960,* (Cambridge: Harvard University Press, 1964), p. 573.

27. Report of the Committee, op. cit., p. 33.

28. Ibid., p. 34.

29. Ibid., p. 35.

30. Ibid., p. 36. The Committee's reference to the "well-established principles of existing law" must be taken with a grain of salt in view of the comments described earlier regarding the confusing state of the case law concerning the definition of charity.

31. Charities Act, 1960, 8 & 9 Eliz. II, ch. 58; See, Keeton, op. cit., p. 227, reprint of the Act in its entirety.

32. William A. Orton, "Endowments and Foundations," in the *Encyclopedia of the Social Sciences,* vol. 5, (New York: The Macmillian Co., 1931), p. 531.

33. Jordan, op. cit., pp. 23-4.

34. Ibid., p. 111.

35. H.G. Carter & F.M. Crawshaw, *Tudor on Charities,* 5th ed., (London: Sweet & Maxwell, Ltd., 1929), p. 2.

36. Jones, op. cit., p. 59.

37. Keeton, op. cit., p. 1.

38. Report of the Committee, op. cit., p. 70.

39. Charities Act, 1960, op. cit., Part III.

40. Marion R. Fremont-Smith, *Foundations and Government* (New York: Russell Sage Foundation, 1965), p. 34.

41. Ibid., p. 35.

42. Owen, op. cit., p. 5.

43. Amherst Tyssen, *The Law of Charitable Bequests,* (London: Sweet & Maxwell, Ltd., 1888), p. 2, quoted in Fremont-Smith, op. cit., p. 35.

44. Charities Act, 1960, op. cit., Part V, §45(1).

45. Jones, op. cit., p. 51.

46. Ibid., p. 25.

47. By the end of the seventeenth century this system of enforcing charitable trusts by commissioners appointed under the 1601 Statute had largely fallen into disuse. Jones, op. cit., p. 56. Thus, the preamble long outlived the substantive provisions of the statute.

48. Ibid., p. 160.

49. Ibid., p. 162.

50. Ibid., p. 168.

51. Ibid.

52. Report of the Committee, op. cit., p. 25.

53. Ibid., p. 26.

54. Charities Act, 1960, op. cit.

55. *Tudor on Charities,* op. cit., p. 407.

56. Ibid.

57. Keeton, op. cit., p. 225.

58. General Rate Act 1967, §40. For a good description of the history of the liability of charity property for local rates, see Owen, op. cit., p. 340, *et seq.* and Keeton, op. cit., p. 212 *et seq.*

59. *Commissioner of Income Tax v. Pemsel* [1891] A.C. 531.

60. Contributions to charity are not generally deductible, but the effect of a deduction can be obtained by a covenant to pay a sum of money to a charity out of an individual's income for a specified term of not less than six years. There is no exemption for charitable legacies from death duties.

61. Royal Commission on the Taxation of Profits and Income – Final Report (London: Government publication, 1955), pp. 56-57.

62. Ibid., p. 57.

63. Ibid.

64. Ibid., p. 352.

65. Under the Recreational Charities Act of 1958, it is "charitable to provide, or assist in the provision of, facilities for recreation or other leisure time occupation, if the facilities are provided in the interests of social welfare." CCH British Tax Guide, vol. 1, at ¶1-02. The Income and Corporation Taxes Act of 1970 made no basic change in the definition of charity for tax exemption purposes, an exempt organization being generally defined in Section 360 of the Act as a "body of persons or trust established for charitable purposes only." Ibid., at ¶21-01.

66. Edith L. Fisch, Doris J. Freed and Esther R. Schachter, *Charities and Charitable Foundations*, (Pomona, New York: Lond Publications, 1974), p. 20.

67. Howard S. Miller, *The Legal Foundations of American Philanthropy 1776-1844*, (The State Historical Society of Wisconsin, 1961), p. 4; Robert H. Bremner, *American Philanthropy*, (Chicago: The University of Chicago Press, 1960), pp. 24-25.

68. Neill H. Alford, Jr., *Charitable Dispositions – Form of Modern Charity Based in American Past*, Virginia Law Weekly (Charlottesville, Va.), Oct. 4, 1962, p. 1, col. 1.

69. Miller, op. cit., p. xi.

70. Alford, op. cit., p. 1, col. 1.

71. Ibid.

72. Fremont-Smith, op. cit., p. 37.

73. The Pennsylvania Constitution of 1776 provided that "all religious societies or bodies of men heretofore united or incorporated for the advancement of religion or learning or for other pious and charitable purposes, shall be encouraged and protected in the enjoyment of the privileges, immunities and estates which they were accustomed to enjoy, or could of right have enjoyed, under the laws and former constitution of this state." Pa. Const. 1776, ch. II §45, as quoted in *The Proceedings of Pennsylvania Constitutional Conventions, 1776-1790*, (Harrisburg: John S. Wiestling, 1825). The same provision was adopted almost verbatim in the Vermont Constitution of 1777, ch. II, §41. The Massachusetts Constitution of 1780 stressed the encouragement of public and private educational institutions and made it the duty of its legislators and magistrates "to countenance and inculcate the principles of humanity and general benevolence, public and private charity . . . among the people." Similar provisions appeared in the New Hampshire Constitution of 1784. See Miller, op. cit., pp. 15-18, for more detailed discussion.

74. Miller, op. cit., pp. 18-19; Fremont-Smith, op. cit., pp. 37. The fear that churches would come to possess inordinate amounts of wealth was expressed by James Madison in writing that "there may be less danger that Religion, if left to itself, will suffer from a failure of pecuniary support applicable to it than that an omission of the public authorities to limit the duration of their Charters to Religious Corporations and the amount of property acquirable by them, may lead to an injurious accumulation of wealth from lavish donations and bequests promoted by a pious zeal or by an atoning remorse." 9 Madison, Writings (Hunt ed. 1910) 487 (letter to Rev. Adams 1832), reprinted in Fisch, Freed and Schachter, op. cit., p. 23.

75. Miller, op. cit., p. 8; Acts of 1805-1806, ch. 74, in Code of Virginia (1849), ch. 77, Sec. VIII, 362; Maryland Constitution 1776, Declaration of Rights, Art. 34.

76. Fremont-Smith, op. cit., p. 36.

77. Miller, op. cit., p. xi.

78. "Of the fifteen states which had occasion to consider the cy pres doctrine by 1860 the courts of some ten states had either condemned or repudiated the doctrine." Fisch, Freed and Schachter, op. cit., p. 21, n.5. See discussion pp. 168-170.

79. 4 Wheat 1, 4 L.Ed. 499 (1819).

80. 2 How. 127, 11 L. Ed. 205 (1844).

81. The District of Columbia courts abandoned the rule of the Philadelphia Baptist Association case in 1877 and the rule in Virginia, Maryland, and West Virginia was changed by statute in the twentieth century. See discussion in Fisch, Freed and Schachter, op. cit., pp. 156-159; Bogert, Trusts and Trustees §322, pp. 647-650 (2d ed. 1964).

82. *First Society M.E. Church of Newark* v. *Clark*, 41 Mich. 730, 3 N.W. 207 (1879); *Little* v. *Willford*, 31 Minn. 173, 17 N.W. 282 (1883); *Holmes* v. *Mead*, 52 N.Y. 332 (1873); *Ruth* v. *Oberbrunner*, 40 Wis. 238 (1876). See discussion in Fisch, Freed and Schachter, op. cit., pp. 160-168; Bogert, op. cit., at §322, pp. 651-653.

83. See discussion in IV Scott on Trusts §348.3 (3d ed. 1967). Bogert, op. cit., at §322.

84. Fremont-Smith, op. cit., p. 40.

85. New York, for example, passed a general incorporation act for religious purposes in 1784, and adopted the first act permitting general incorporation for business purposes in the U.S. in 1811. Ch. 67, [1811] N.Y. Laws 34th Sess. 111.

86. Fremont-Smith, op. cit., p. 41.

87. William L. Cary and Craig B. Bright, *The Law and the Lore of Endowment Funds* (New York: The Ford Foundation, 1969), p. 14.

88. Fremont-Smith, op. cit., p. 41.

89. Cary and Bright, op. cit., pp. 15, 26-27.

90. As of the end of 1973, the act had been enacted into law in California, Colorado, Connecticut, Illinois, Kansas, Maine, Maryland, Minnesota, New Hampshire, Tennessee, Vermont, Virginia, and Washington. For discussion of the act see William L. Cary and Craig B. Bright, *The Developing Law of Endowment Funds: "The Law and the Lore" Revisited* (New York: The Ford Foundation, 1974), pp. 12-14.

91. Note, "Tax Exemptions, Subsidies and Religious Freedom After Walz v. Tax Commission," 45 N.Y.U. L. Rev. 876, 880 (1970).

92. Carl Zollman, *American Civil Church Law*, Studies in History, Economics and Public Law, vol. 77 (New York: Columbia University, 1917).

93. *State* v. *Collector of Jersey City*, 24 N.J.L. 108, 120 (1853).

94. Frank W. Blackmar, *The History of Federal and State Aid to Higher Education in the United States* in Contributions to American Educational History (Bureau of Education, Government Printing Office, Washington, D.C., 1890).

95. Phillip Adler, *Historical Origin of Tax Exemption of Charitable Institutions* in Tax Exemptions on Real Estate – An Increasing Menace, Pt. I (The Westchester Co. Chamber of Commerce, 1922).

96. Fisch, Freed and Schachter, op. cit., p. 598 and authorities cited therein.

97. See, e.g., Pa. Stat. Ann. tit. 72, §2485-302 (Purdon 1964).

98. See, e.g., N.Y. Tax Law §359(2) (g) (McKinney Supp. 1974).

99. See, e.g., N.Y. Tax Law §1116(a) (4) (McKinney Supp. 1974).

100. See. e.g., N.Y. Real Prop. Tax Law §421 (McKinney Supp. 1974).

101. See, e.g., R.I. Gen. Laws §44-3-3(7) (Supp. 1968). A limited exemption from tax on real property is also provided for "a school, academy or seminary of learning, and of any incorporated public charitable institutions." R.I. Gen. Laws §44-3-3(8) (Supp. 1968).

102. See, e.g., Conn. Gen. Stat. Ann. §12-81(7) (1972).

103. N.Y. Real Prop. Tax Law §421 (McKinney Supp. 1974).

104. Pa. Stat. Ann. tit. 72, §3244 (Purdon 1964).

105. N.Y. Tax Law §601(d) (McKinney Supp. 1974).

106. N.Y. Real Prop. Tax Law §421 (McKinney Supp. 1974).

107. Compare *Dulles* v. *Johnson*, 273 F. 2d 362 (2d Cir. 1959), *cert. denied*, 364 U.S. 834 (1960) (holding the Association of the Bar of the City of New York to be "charitable, scientific, [and] educational" for federal estate tax purposes) with *Association of the Bar of the City of New York* v. *Lewisohn*, 34 N.Y. 2d 143, 313 N.E. 2d 30 (1974) (holding the Association to be taxable as a bar association and not primarily charitable or educational, for purposes of real property taxation).

108. Ch. 414, §2(1) (b), [1971] McKinney's Sess. Laws of N.Y. 598.

109. Ch. 414, §2(1) (a), [1971] McKinney's Sess. Laws of N.Y. 598. The law was again amended in 1972 to provide mandatory exemption for institutions organized or conducted exclusively for moral or mental improvement of men, women or children. Ch. 529, §1, [1972] McKinney's Sess. Laws of N.Y. 1066.

110. Earlier federal income tax statutes in force briefly during and after the Civil War applied only to certain specified classes of business corporations, such as railroads, canal companies, and banks. Accordingly, no exemption provisions were needed to relieve charitable corporations from such taxes. See ch. 45, 12 Stat. 292 (1861); ch. 119, 12 Stat. 432 (1862); ch. 74, 12 Stat. 713 (1863); ch. 173, 13 Stat. 223 (1864); ch. 78, 13 Stat. 469 (1865); ch. 15, 14 Stat. 4 (1866); ch. 184, 14 Stat. 98 (1866); ch. 169, 14 Stat. 471 (1867); ch. 255, 16 Stat. 256 (1870).

111. Revenue Act of 1894, ch. 349, §32, 28 Stat. 556 (1894).

112. *Pollock* v. *Farmer's Loan and Trust Co.*, 158 U.S. 601 (1895).

113. Corporation Excise Tax of 1909, ch. 6, §38, 36 Stat. 113 (1909).

114. Revenue Act of 1913, ch. 16, 38 Stat. 114 (1913).

115. Revenue Act of 1916, ch. 463, §11a(6), 39 Stat. 766 (1916).

116. Revenue Act of 1918, ch. 18, §231(6), 40 Stat. 1076 (1918).

117. Revenue Act of 1918, ch. 18, §231(6), 40 Stat. 1076 (1918).

118. Revenue Act of 1921, ch. 136, 42 Stat. 227 (1921).

119. Internal Revenue Code of 1954, ch. 1, subch. F, §501(c) (3), 68A Stat. 163 (1954).

120. Revenue Act of 1934, ch. 277, 48 Stat. 680 (1934).

121. Internal Revenue Code of 1954, ch. 1, subch. F. §501(c) (3), 68A Stat. 163 (1954).

122. Ch. 448, §29, 30 Stat. 464 (1898).

123. Ch. 806, Schedule B, 31 Stat. 946 (1901).

124. Ch. 1160, 32 Stat. 406 (1902).

125. Ch. 463, tit. II, 39 Stat. 777 (1916).

126. Ch. 63, tit. XII, §1201(2), 40 Stat. 300 (1917). In 1944, the deduction limitation was liberalized to 15% of adjusted gross income. Individual Income Tax Act of 1944, ch. 210, §8(b), 58 Stat. 231 (1944). The limitation was again increased, in 1952, to 20% (Internal Revenue Code of 1939, §23(o) as amended, ch. 588, §4(a), 66 Stat. 443 (1952)), in 1954, to 30% for contributions to certain public charities (Internal Revenue Code of 1954, §170(b) (1)), and in 1969, to 50% for contributions to certain public charities (Internal Revenue Code of 1954, §170(b)).

127. Revenue Act of 1918, ch. 18, tit. IV, §403(a) (3), 40 Stat. 1057 (1919).

128. Revenue Act of 1926, ch. 20, tit. 26, §1095, 44 Stat. 835 (1926).

129. Revenue Act of 1935, ch. 829, §102(c), 49 Stat. 1016 (1935).

130. Internal Revenue Code of 1954, §4941.

131. Internal Revenue Code of 1954, §4943.

132. Internal Revenue Code of 1954, §4942.

133. Internal Revenue Code of 1954, §4944.

134. Internal Revenue Code of 1954, §4945.

135. Internal Revenue Code of 1954, §4940.

136. The practice of the IRS is delineated in Tax Analysts and Advocates, IRS Operating Instructions for Rulings Personnel, *Exempt Organizations Handbook* (hereinafter cited to as "Exempt Organizations Handbook") at 715.1 which states:

> "IRC 501(c) (3) covers only corporations, community chests, funds and foundations. This means that some kinds of groupings can qualify and some cannot. Evidently, an individual cannot be exempt. Neither can a partnership. By the same token, a formless aggregation of individuals cannot be exempt.

and at 715.2

> "(3) Associations – A formless aggregation of individuals without some organizing instrument, governing rules, and regularly chosen officers would not be a 'corporation, community chest, fund, or foundation' for purposes of IRC 501(c) (3). However, the typical nonprofit association formed under a constitution or bylaws, with elective officers empowered to act for it, would be treated as a corporation for purposes of IRC 501(c) (3)."

Although the Exempt Organizations Handbook does not have the force of a regulation or published ruling, it illustrates the IRS practice of treating organizations as within the scope of section 501(c) (3) even if they do not meet strict standards of corporate organization, so long as they follow some sort of systematic procedures, and so long as the organization is not formed and operated by only one person. Ibid., at 715.3.

137. Int. Rev. Code of 1954, §7701 and the regulations thereunder distinguish partnerships from corporations, but imply that funds or foundations are akin to corporations. In the only case in which the IRS has rejected a partnership, it has prevailed. *Emerson Institute* v. *United States*, 356 F.2d 824 (D.C. Cir. 1966).

138. Reg. §1.501(c) (3)–1(b) (2).

139. Exempt Organizations Handbook at 732(2).

140. The doctrine of looking beyond the charter to the intent of the founders of the organization, which doctrine antedates the regulations establishing the organizational test, originated with the case of *Roche's Beach, Inc.* v. *Commissioner*, 96 F.2d 776 (2d Cir. 1938), in which the court stated: "[The IRS] denied exemption on the theory that the stated purposes for which a corporation is organized must be found in its charter. We think this is too narrow a view." Ibid., p. 778.

The doctrine was amplified in Forest Press, Inc., 22 T.C. 265, 269 (1954), in which the court stated: "While a reading of the petitioner's charter might imply that it was not organized exclusively for educational purposes, we think that such inferences are clearly displaced by the uncontradicted reasons for the petitioner's creation . . ."

And in *Elision Guild, Inc.* v. *United States*, 412 F.2d 121 (1st Cir. 1969), the court construed the bylaws of the organization in order to decide if the charter met the organizational test.

Finally, in the recent Tax Court memorandum decision, John T. Blake, 29 T.C.M. 513 (1970), the court allowed a deduction under section 170 (which has identical language to that in section 501(c) (3), including the phrase "organized and operated") when a church, which was the recipient of the contribution, did not have any organizing papers. The court stated: "While there is no charter or other document setting forth the purpose for which the Word of Life Church was organized, this is not fatal to the petitioner's case. It has been held that the question of purpose is one of fact to be determined from an examination of all the evidence, including the activities carried on." Ibid., p. 515.

One commentator summarizes the trend as follows: "In general, the courts have not accorded separate consideration to the formal vehicle utilized by an exempt organization but, instead, they have treated 'organized' and 'operated' as a single requirement and have examined the operating history of the organization rather than dwelling upon the content of the trust instrument or the corporate charter and bylaws." Weithorn, Tax Techniques for Foundations and Other Exempt Organizations, §32.01(1) (1964).

141. Reg. §1.501(c) (3)–1(b) (1) (i) (a).

142. Reg. §1.501(c) (3)–1(b) (1) (ii).

143. Ibid.

144. Even though the IRS takes the position that a statement of purposes which is only limited by the language of the Code itself meets the organizational test requirement of having limited purposes, the regulations require that "An organization [in order to establish its exemption,] . . . shall submit with, and as a part of, [its application for exemption] . . . a detailed statement of its proposed activities." Reg. §1.501(a)–1 (b) (1) (iii).

145. Reg. §1.501(c) (3)–1(b) (1) (iv).

146. In one case in which the IRS has attempted to argue that the purposes were not sufficiently limited, it is interesting to note that the court adopted the same basic position taken in regard to whether or not the "articles of organization" have to be spelled out in a founding document. In Broadway Theatre League of Lynchburg, 293 F. Supp. 346 (W. D. Va. 1968), a clause in the organization's charter stated that the group would attempt to create a community interest in "good theatrical performances of all kinds." The IRS argued that the word "all" was unlimited, and therefore the charter violated the organizational test requirement of having a statement of purposes limited to exempt purposes. The court held that "the use of the word 'all' can [not] be extracted and used as a sword" to deny exemption. Additionally, the court stated that "[i] t is not unusual for charters of corporations to grant broad powers that are never intended to be used." Ibid., p. 352. The opinion clearly illustrates the wide gap between the court's decision and the IRS position: "To a degree the test of organization cannot be separated from the test of operation." Ibid., p. 351.

147. Reg. §1.501(c) (3)–1(b) (iii).

148. Ibid. Note that an organization can engage in manufacturing as part of an educational program designed to teach trade and business skills. See, Rev. Rul. 73-128, 1973-1 C.B. 222.

149. The question of what is "insubstantial" rarely arises under the organizational test. "As a practical matter (particularly in connection with securing Internal Revenue Service tax exemption rulings), it is difficult to contemplate how the language of a charter could be phrased so as to authorize engaging in such nonexempt activities while, at the same time, limiting them in accordance with the 'insubstantial' activities rule of the Regulations." Weithorn, op. cit., at §32.02[2].

150. In *Lewis* v. *United States*, 189 F. Supp. 950 (D. Wyo. 1961), a trust empowered the trustees to ". . . hold, maintain, operate or continue, at the risk of the trust estate, so long as they deem it advisable, any and all property or business which it may receive hereunder." Ibid., p. 952.

The IRS took the position that this provision authorized general commercial pursuits. Noting that the trust had not in fact engaged in any such activities and had liquidated the profit making businesses, including a ranch, which it had acquired at its formation, the court rejected the IRS contention that the organizational test had not been met. And, in *Passaic United Hebrew Burial Association v. United States*, 216 F. Supp. 500, 505 (D.N.J. 1963), the court stated that "The term 'organized' refers to the purpose of the organization as evidenced by the corporate charter and the factual circumstances surrounding its adoption and operations thereunder."

Thus, even though the charter of the organization reads as if it might include unrelated business activities, the court, after considering the "factual circumstances" and the organization's operations, effectively ignored the anomalies of the charter.

151. Reg. §1.501(c) (3)–1(b) (4).

152. Some such state laws are drafted in specific reference to the Internal Revenue Code Provisions. See N.Y. E.P.T.L. §8-1.8 (McKinney 1971).

153. T.I.R. 359, January 18, 1962, 6 P-H 1962 Fed. Taxes ¶54-635.

154. Ibid.

155. "The government stresses that the Articles of Organization did not as of 1962 specifically provide that the taxpayer's property should on dissolution be used only for exempt purposes. Once again, however, no authority is cited that supports the notion that the Articles must specifically so provide." *Elisian Guild v. United States*, op. cit., pp. 123-4.

156. See, e.g., C.F. Smith Co., 13 T.C.M. 607 (1954).

157. *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633 (8th Cir. 1963). The court presumed that it was up to the IRS to prove that state law would clearly show that the assets would revert to the donor.

158. The issue has only been faced, recently, in revenue rulings. See, e.g., Rev. Rul. 66-259, 1966-2 C.B. 214. Although such a charter provision would seem logically to violate the "exclusively organized" language of Section 501 (c) (3), there is judicial authority supporting the proposition that even a benefit specifically provided for in the charter may be acceptable if the benefit is small. Miss Harris' Florida School, Inc., 9 P-H BTA Memorandum Decisions ¶40,275 (1940).

Weithorn summarizes the attitude of the courts as follows: "Where the Service has looked to the hypothetical, future event of dissolution and argued, generally as a secondary issue, that the lack of a 'charitable disposition' charter provision (in such event) bars an organization from attaining exempt status, the courts have disposed of the question by stating that it would be faced when, as, and if it ever arose." Weithorn, op. cit., at § 32.02[5] (1974 Supp.).

159. Reg. § 1.501(c) (3)–1(c) (1).

160. Int. Rev. Code of 1954, § 501 (c) (3). The less stringent standards imposed by the "primary activities" test resulted from court decisions which antedated the regulations under section 501(c) (3). See, Weithorn, op. cit., at § 32.03[1] and cases cited therein.

161. "The draftsmen might more easily have said 'exclusively' means 'almost exclusively' and let it go at that. Words like 'principal,' 'primary,' 'predominant,' 'incidental,' 'secondary,' 'subsequent,' 'substantial,' and 'less than substantial' lead almost inevitably to litigation, since they are tests without adequate objective standards." Young and Galvin, "Proposed Regulations do not Clarify Tax Status of 'exempt organizations'," 5 J. Taxation 298, 299 (November 1956).

162. See discussion of political activities, page 1929.

163. The Exempt Organizations Handbook, at 741.1(2) states: "The regulations' terms 'exclusively,' 'primarily' and 'insubstantial' present difficult conceptual problems. Questions involving the application of these terms can more readily be resolved on the basis of the facts of a particular case. It is therefore important that all the facts and circumstances be fully developed."

164. Reg. § 1.501(c) (3)–1(d) (1) (ii).

165. Ibid.

166. Reg. § 1.501(c) (3)–1(c) (2).

167. Reg. § 1.501(a)–1 (c). See also, *Universal Church of Scientific Truth, Inc.* v. *United States*, 32 AFTR 2d 73-6122 (N.D. Ala. 1973).

168. *Horace Heidt Foundation* v. *United States*, 170 F. Supp. 634 (Ct. Cl. 1959).

169. See, e.g., Texas Trade School, 30 T.C. 642 (1958).

170. *Hope Charitable Foundation* v. *Riddell*, 7 AFTR 2d 1441 (S.D. Cal. 1961). In this case the court rejected the contention of the IRS.

171. See, e.g., Int. Rev. Code of 1954, § 4941(d) (2) (E); Rev. Rul. 73-126, 1973-1 C.B. 220 (Pensions for past services are permissible when reasonable in amount).

172. See, *Cleveland Chiropractic College* v. *Commissioner*, 312 F.2d 203 (8th Cir. 1963).

173. *Enterprise Railway Equipment Co.* v. *U.S.*, 161 F. Supp. 590, 595 (Ct. Cl. 1958); Rev. Rul. 73-126, op cit.

174. Exempt Organizations Handbook, op cit., at 744.4(5).

175. American Society of Cinematographers, Inc., 42 B.T.A. 675 (1940).

176. Exempt Organizations Handbook, op. cit., at 743.5.

177. Reg. § 1.501(c) (3)–1(b) (iii).

178. George E. Turnure, 9 B.T.A. 871, 874 (1927). Although this case is an old one, it has been cited rather frequently, and it remains an important case in this area. See also, Estate of Ellen Battell Stoeckel, 2 T.C. 975 (1943), and *Kenner* v. *Commissioner*, 318 F.2d. 632 (7th Cir. 1963).

179. A good example of how large organizations can provide substantial social benefits to members, yet remain exempt because such benefits constitute only a small amount of the total budget of the organization, is provided by Estate of Phillip R. Thayer, 24 T.C. 384 (1955). The case involves a large and particularly active alumni association.

180. Although several bills relating to the political activities of 501(c) (3) organizations have recently been proposed, no bill has passed either House of Congress. Public Law 93-625, 93rd Congress., 2nd Session, H.R. 421, signed into law on January 3, 1975, created section 527 of the Internal Revenue Code, dealing generally with political organizations. Although the legislative history of this law indicates that it was not intended to alter the current rules with respect to the political activities of 501(c) (3) organizations, "[t]he differences in [the bill's] language compared to section 501 (c) (3), particularly the references to 'selection' and 'appointment,' raise the theoretical possibility that a foundation activity permissible under section 501 (c) (3) and 4945 could be subject to tax under section 527." Council on Foundations, Inc., memorandum, January 29, 1975, p. 2.

181. The question of political activity has important implications for a broad spectrum of 501(c) (3) organizations. Religious groups, for example, have felt impelled to take political stands because of the moral imperatives of their faith. See, "The Revenue Code and a Charity's Politics," 73 *Yale L.J.* 661 (1963). For a discussion of how colleges and universities have faced this issue, see, Goldberg, "Guarding Against Loss of Tax Exempt Status Due to Campus Politics," 33 *J. Taxation* 232 (1970). The enactment of political restrictions on foundations in the Tax Reform Act of 1969, which restrictions were in addition to, and stricter than, those already contained in section 501(c) (3), produced apprehension in some quarters. See, "Regulating the Political Activity of Foundations," 83 *Harv. L. Rev.* 1843 (1970).

There is a long history of academic, and other, discussion of the provisions prohibiting "substantial" political activity as well as a long history of judicial examination of the issue. The common point of agreement which has emerged is to the effect that

"... although the policy against political activities as expressed in the exempting provision

> appears to be well-established, neither the extent of the proscription nor its rationale has ever been clearly enunciated by Congress.
>
> The Courts and the Treasury have not clarified the statutory policy by interpretation." Ibid., p. 1845.

Although the 1959 regulations dealt with the problem by creating the definition of an "action" organization, it was soon noted that under the new regulations "The standards for determining whether an organization is an 'action' organization [were], in some respects, more vague than the statute." Ibid., p. 1847, n. 19.

182. A recent example is *Haswell* v. *United States*, 500 F.2d 1133 (Ct. Cl. 1974), where a charitable contribution deduction was denied because the organization was held to have engaged in substantial lobbying activity.

183. Reg. § 1.501(c) (3)–1(c) (3) (ii).

184. The activities (listed in the text) that the IRS has held to be "contacts" or "urgings" are from the letter ruling issued by the IRS when it revoked the exemption of the Sierra Club. The letter ruling is reprinted at 6 P-H 1967 Fed. Taxes ¶ 54,664. For a discussion of the Sierra Club revocation and the political limitations under section 501(c) (3), see Caplin, "Limitations on Exempt Organizations: Political and Commercial Activities," *8th Biennial Conference on Charitable Foundations* 265 (H. Sellin ed. 1967).

185. Caplin, op. cit., p. 274.

186. Rev. Rul. 70-449, 1970-2 C.B. 112. See also, Reg. § 53.4945-2. This exception may not be available if the invitation to appear before a legislative committee is arranged by the organization itself. See also, *Haswell* v. *United States*, op. cit.

187. See, e.g., Alan B. Kuper, 22 T.C.M. 1208 (1963), aff'd, 332 F.2d 562 (3rd Cir. 1964), *cert. denied* 379 U.S. 920 (1964); *Haswell* v. *United States*, op. cit.

188. Stephen R. Field, "Tax Exempt Status of Universities: Impact of Political Activities by Students," 24 *The Tax Lawyer* 157, 167 (1970). As an example, Field cites Rev. Rul. 67-293, 1967-2 C.B. 185.

189. Testimony of Treasury Secretary Dillon, *Hearings before Senate Finance Committee on H.R. 10650*, 87th Congress, 2nd Session, Part 10, at 4365-6 (May 11, 1962). The origins of the five percent rule are traced to the case of *Seasongood* v. *Commissioner*, 227 F.2d 907 (6th Cir. 1955), in which the court used that figure as a "rule of thumb."

190. Exempt Organizations Handbook, at 764(1).

191. *Dulles* v. *Johnson*, 273 F.2d 362 (2d Cir. 1959). For other examples of the balancing test used by the courts in determining whether the activities were "substantial" see, e.g., *Seasongood* v. *Commissioner*, op. cit; *Krohn* v. *United States*, 246 F. Supp. 341 (D. Col. 1965). Courts sometimes attempt to avoid applying the "substantial" test, and instead concentrate on whether the "purpose" of the organization is charitable instead of political. See, *International Reform Federation* v. *District Unemployment Compensation Board*, 131 F.2d 337 (D.C. Cir. 1942).

192. Reg. § 1.501(c) (3)–1(d) (3) (i) (b).

193. Reg. § 1.501(c) (3)–1(d) (3) (ii), Example (2). Rev. Rul. 74-574, 1974-2 C.B. 160, holds that an educational broadcasting station does not violate the action organization prohibitions in providing free air time to political candidates in compliance with the equal opportunities requirements of the Federal Communications Act of 1934, as amended.

194. Reg. § 1.501(c) (3)–1(d) (2).

195. Rev. Rul. 66-258, 1966-2 C.B. 213. There are a number of cases involving organizations whose purpose is to increase government honesty and efficiency. Several have involved the League of Women Voters. See, e.g., Henriette T. Noyes, 31 B.T.A. 121 (1934) holding the

Minnesota League of Women Voters and the National League of Women Voters not to be exempt because one of their principal purposes was influencing legislation, and, therefore, they were not organized for exclusively educational purposes; Luther E. Smith, 3 T.C. 696, 704 (1944) holding a contribution to St. Louis League of Women Voters to be deductible during a year in which the organization did not engage in substantial legislative activity; *Liberty Nat. Bank and Trust Co.* v. *United States*, 122 F. Supp. 759 (W.D.Ky. 1954) holding the Louisville League of Women Voters to be exempt since influencing legislation was a minor part of the organization's activities. *Seasongood* v. *Commissioner*, op. cit., on which the 1959 regulations were in part based, involved a "good government league," which worked "unselfishly in the public interest" to improve the local political situation, and as a means to that end was active in "investigating proposed legislation and . . . endorsed candidates . . . and sponsored or opposed legislation through contacts with legislative authorities." Although the court's decision upholding the validity of the league's exemption is somewhat unclear, the court seemed to approach the issue by applying the tests listed above. First, it found that the political activity was closely related to the league's exempt purpose ". . . there is nothing in the findings of fact that either challenges the validity, the good faith purpose . . . in the communications addressed by the League . . . to legislative or administrative officers." Secondly, the court determined that the nature of the contracts was benign. "Nothing in the record indicates lobbying, influence peddling or illegal or unethical pressures upon legislators." Ibid., p. 912.

196. Reg. § 1.501(c) (3)–1(c) (3) (iii).

197. Rev. Rul. 67-71, 1967-1 C.B. 125; See also, Rev. Rul. 67-368, 1967-2 C.B. 194.

198. Exempt Organizations Handbook, at 770(2).

199. See, Goldberg, op. cit., for a discussion of campus newspapers endorsing political candidates.

200. As, for example, where a political science course requires students to participate in a political campaign, the purpose being the students' education, Rev. Rul. 72-512, 1972-2 C.B. 246; or, when an organization participates with the purpose of securing "historically important" materials, Rev. Rul. 70-321, 1970-1 C.B. 129. Some types of quasi-political activity, even though not "on behalf of" a particular candidate, may lead directly to one or another candidate winning. Thus, the supporters of Seth Taft, Republican candidate for Mayor of Cleveland who was defeated by Carl Stokes, a Black and a Democrat, attributed the defeat to the voter registration drive financed by a 501(c) (3) organization. This was one of the incidents leading to the enactment of strict limits on private foundation activity in political campaigns in the 1969 Tax Reform Act, which, however, did not change the requirements laid down in section 501(c) (3). For a discussion of the Cleveland election see Note, "Political Activity and Tax Exempt Organizations Before and After the Tax Reform Act of 1969," 38 *Geo. Wash. L. Rev.* 1114, 1127 (1970).

201. Reg. § 1.501(c) (3)–1(c) (3) (iv).

202. From the "Fellowship of Reconciliation, That Men May Live – Statement of Purpose," quoted in "The Revenue Code and a Charity's Politics," op. cit., p. 662, n. 8.

203. Letters from Director, Tax Rulings Division, Internal Revenue Service, to the Fellowship of Reconciliation, Nyack, New York, May 6, 1963, 6 P-H 1963 Fed. Taxes ¶ 54,825.

204. Reprinted at 6 P-H 1964 Fed. Taxes ¶ 54,932. For a discussion of this case see "The Revenue Code and a Charity's Politics," op. cit. Reversals of IRS position, leading to uncertainty, have occurred in other situations involving the political regulations. See examples cited in "The Tax Treatment of Business Grassroots Lobbying: Defining and Attaining the Public Policy Objectives," 68 *Colum. L. Rev.* 801, 829 (1968).

205. See, "The Revenue Code and a Charity's Politics," op. cit., p. 668.

206. Martha Hubbard Davis, 22 T.C. 1091, 1100 (1954); for a discussion of the judicial reaction to organizations whose aim or effect is to influence legislation, see, Clark, "The Limitation on Political Activities: A Discordant Note in the Law of Charities," 40 *Va. L. Rev.* 439 (1960). See also, Caplin, op. cit.

207. Reg. §1.501(c) (3)–1(d) (2).

208. *Jackson* v. *Phillips*, 14 Allen (Mass.) 539, 556 (1867).

209. *Commissioner of Income Tax* v. *Pemsel*, [1891] A.C. 531, 583. The description of charitable purposes set forth in the Restatement of Trusts is similar to the foregoing and reads as follows:

> "§368. What Purposes Are Charitable
>
> Charitable purposes include
>
> (a) the relief of poverty;
> (b) the advancement of education;
> (c) the advancement of religion;
> (d) the promotion of health;
> (e) governmental or municipal purposes;
> (f) other purposes the accomplishment of which is beneficial to the community."
> Restatement (Second) of Trusts §368 (1957).

210. Reg. §1.501(c) (3)–1(d) (2).

211. IV Scott on Trusts § 368, at 2855 (3d ed. 1967).

212. Bogert, op. cit., §369, p. 62 (2d ed. 1964). See also, Restatement (Second) of Trusts §368 (1957).

213. Ibid., §369, pp. 62, 63.

214. *Todd* v. *Citizens Gas Company of Indiana*, 46 F.2d 855, 865 (7th Cir. 1931).

215. *People* v. *Dashaway Association*, 84 Cal. 114, 116 24 P. 277, 279 (1890).

216. *Eastern Kentucky Welfare Rights Organization* v. *Simon*, 506 F.2d 1278, 1288-9 (D.C. Cir. 1974).

217. IV Scott on Trusts §375.2, at 2920 (3d ed. 1967).

218. In Matter of Bedford-Stuyvesant Restoration Corporation, 172 NYLJ 11 (1974), Bedford-Stuyvesant Restoration Corporation and Sheffield Rehabilitation Corporation brought a proceeding in which they sought a judgment setting aside a determination of the tax commission denying the petitioners' application for exemption from real estate taxes under section 421 of the Real Property Tax law. The New York Supreme Court, Special Term held that the petitioner's activities did not qualify as charitable within the precise language of section 421 of the RPTL in spite of the fact that petitioners had qualified as exempt organizations under section 501(c) (3) for federal income tax purposes.

Similarly, in *Association of the Bar of the City of New York* v. *Lewisohn*, 34 N.Y. 2d 143 (1974), the New York Court of Appeals held that the Association of the Bar of the City of New York is not organized and conducted primarily for charitable or educational purposes within the language of section 421 of the RPTL in spite of the decision in *Dulles* v. *Johnson*, 273 F.2d 362 (2d Cir. 1959), 364 U.S. 834 (1960) holding the Bar Association of the City of New York to be a "charitable, scientific [and] educational" organization for federal estate tax purposes under section 812(d) of the Internal Revenue Code.

219. *Green* v. *Connally*, 330 F. Supp. 1150 (D.D.C. 1971), aff'd. mem. *sub nom*, *Coit* v. *Green*, 404 U.S. 997 (1971).

220. Bogert, op. cit., §369.

221. Restatement (Second) of Trusts §368, Comment b, at 248 (1957).

222. For example, in the memorandum of May 16, 1973, prepared by the IRS explaining its reason for denying the application of the Center on Corporate Responsibility for tax exemption under section 501(c) (3), the Service stated that "the determination of 'community benefit'

'turns not on . . . any hard and fast formulas as to what is beneficial to the community, but whether the courts regard or would regard the particular benefit to the community, as sufficient to outweigh or warrant the detriments entailed in devoting property to such use in perpetuity, relieving it of the burden of taxation, etc. Bogert, Trusts and Trustees (2d ed. 1964) §368, 369'." *Center on Corporate Responsibility v. Schultz*, 368 F. Supp. 863, 874, n. 21 (D.D.C. 1973).

223. Fremont-Smith, op. cit., p. 431.

224. Under section 508 of the Internal Revenue Code of 1954 which was added by the Tax Reform Act of 1969, the filing of an exemption application with the IRS is mandatory in the case of all organizations (except churches, certain of their affiliated organizations and certain small publicly supported organizations) formed after October 9, 1969, that seek exemption under section 501(c) (3). Prior to the enactment of section 508, the Internal Revenue Code did not require the filing of such an application with the IRS as a condition for exemption, but most newly formed charities did apply for exemption in order to remove the uncertainty which would have otherwise existed as to their status.

225. Fremont-Smith, op. cit., p. 68. This may be alleviated to some extent if proposed legislation is enacted to enable an organization to take an immediate appeal to the Tax Court if its exemption application under section 501(c) (3) is rejected by the IRS.

226. *Senate Hearings on Tax Exemption for Charitable Organizations – Examination of IRS Decision to Deny Exempt Status.* (Testimony of Commissioner Thrower Before Senate Subcommittee on Employment, Manpower and Poverty) November 16, 1970.

227. *House Committee on Ways and Means*, 92nd Congress, 2d Session, Legislative Activity by Certain Types of Exempt Organizations 5 (Committee Print 1972).

228. Fremont-Smith, op. cit., p. 68.

229. IV Scott on Trusts § 374, at 2903 (3d ed. 1967).

230. *House Committee on Ways and Means*, op. cit., at 5. The Exempt Organizations Handbook, at 747(3), states that one of the "warning signs" that an organization may not be charitable is that the "alleged charitable purpose . . . does not seem to be the fulfillment of any very obvious public need."

231. For a similar classification of these major sectors of our society, see, Hon. Thomas B. Curtis, *It Depends Upon How You Look At It*, in Tax Impacts on Philanthropy 214 (Tax Institute of America, 1972).

232. Charitable Trusts Committee, Report of the Committee on the Law and Practice Relating to Charitable Trusts, pt. I, at 8 (1952).

233. Examples of organizations that have been ruled to be charitable because they lessen the burdens of government are a volunteer, nonprofit fire company (Rev. Rul. 74-361, 1974-2 C.B. 159); an organization that helps policemen and firemen to perform their duties during emergencies (Rev. Rul. 71-99, 1971-1 C.B. 115); and an organization that assists the police department to apprehend criminals by making funds available for the offering of rewards (Rev. Rul. 74-246, 1974-1 C.B. 130). However, an organization formed to assist a newly elected governor of a state to prepare his legislative message is not exempt under section 501(c) (3) because such an activity is directed toward the influencing of legislation. Rev. Rul. 74-117, 1974-1 C.B. 128.

234. The IRS takes the position that a state or municipality does not qualify under section 501(c) (3) "since its purposes are clearly not exclusively those described in section 501(c) (3) . . ." Rev. Rul. 60-384, 1960-2 C.B. 172. However, a separately incorporated instrumentality of a state or municipality may qualify for exemption under section 501(c) (3) if it is a clear "counterpart" of an organization described in that section and is not clothed with enforcement or regulatory powers. Rev. Rul. 60-384, op. cit.; Rev. Rul. 74-14, 1974-1 C.B. 10. It would appear that the same tests would apply to an instrumentality of a foreign government. Reg. §53.4945-5(a) (4) and (5).

235. Sacks, "The Role of Philanthropy: An Institutional View," 46 *Va. L. Rev.* 516, 520 (1960).

236. These provisions are discussed in greater detail in Chapter VIII of this report. The principle described in the text is illustrated by the following rulings in which exemption under section 501(c) (3) was denied: Rev. Rul. 72-369, 1972-2 C.B. 245 (providing managerial consulting services on a cost basis exclusively to 501(c) (3) organizations); Rev. Rul. 73-127, 1973-1 C.B. 221 (operation of a retail grocery store which sells food at a smaller mark-up than competing stores to residents of a poverty area). The IRS will also deny exemption to an organization formed and controlled by a group of 501(c) (3) organizations for the exclusive purposes of providing them with administrative services on a cost-sharing basis. Rev. Rul. 69-529, 1969-2 C.B. 127; see, Reg. §1.502-1(b). However, as discussed hereinafter, two courts have held that the dividing line between the philanthropic sector and private economic sector should not be drawn so restrictively as to exclude such jointly conducted administrative activities from section 501(c) (3). *United Hospital Services v. United States*, 34 AFTR 2d 74-3640 (S.D. Ind. 1974); *Hospital Bureau of Standards and Supplies, Inc. v. U.S.* 158 F.2d 560 (Ct. Cl. 1958). Congress has also recognized the need for 501(c) (3) organizations to be able to carry on certain administrative functions on a joint basis. See sections 501(e) and (f). By comparison, the IRS has ruled that an organization formed by a group of 501(c) (3) organizations for the purpose of assisting them to carry on their exempt functions (as distinguished from administrative functions) may qualify under section 501(c) (3). Rev. Rul. 74-614, 1974-2 C.B. 164. Also, a subsidiary of a single 501(c) (3) organization may qualify under section 501(c) (3) where its activities are "an integral part of the exempt activities of the parent organization, ... for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities." Reg. §1.502(b).

237. In *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938); *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir. 1950); *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951) and other similar cases exemption under the provision of prior law corresponding to section 501(c) (3) was upheld with respect to corporations engaged in business where the profits were used for charitable purposes. The theory was that the taxability of the income was controlled by the destination of the income and not its source. These decisions were legislatively overruled in 1950. The legislative history of the 1950 amendments makes clear that they were intended to prevent "unfair competition" by exempt organizations with private business. S. Rep. No. 2375, 81st Congress, 2d Session, 1950-2 C.B. 482, 504.

238. Rev. Rul. 73-313, 1973-2 C.B. 174.

239. Rev. Rul. 72-559, 1972-2 C.B. 247.

240. Rev. Rul. 70-585 (Situation 3), 1970-2 C.B. 115. It is interesting to note that in Situation 4 of the same ruling the IRS held that an organization is not charitable where it is formed for the purpose of erecting housing to be rented at cost to moderate income families. The ruling stated that a "study of the area shows that because of the high cost of land, increased interest rates, and the growing population, there is a shortage of housing for moderate income families in the community." The rationale of the ruling is that the organization does not qualify under section 501(c) (3) because its program is "not designed to provide relief to the poor or to carry out any other charitable purpose ..." The conclusion could also be explained on the basis that the housing needs of moderate income families have traditionally been met by the private economic sector, and that such needs are therefore not recognized as an appropriate concern of charity. However, it is possible to imagine a situation in which it would not be feasible for the private economic sector to meet the housing needs of moderate income families in a community. In such a case it might be appropriate for charity to meet this need.

241. Rev. Rul. 74-587, 1974-2 C.B. 162. See also, Reg. §53.4944-3, relating to program-related investments by private foundations for the purpose of encouraging economic development and employment opportunities in depressed areas.

242. Rev. Rul. 71-29, 1971-1 C.B. 150. In this ruling the IRS stated that "[t]he charitable element in facilitating public transportation is established in the Statute of Charitable Uses, 43 Eliz. I, c. 4 (1601) which recognized as charitable the 'repair of bridges, ports, havens, causeways ... and highways'." A firmer rationale would seem to be that the unwillingness of

the privately owned bus company to continue providing service at a deficit gave rise to a community need which could appropriately be met by the philanthropic sector.

243. Rev. Rul. 57-467, 1957-2 C.B. 313; Rev. Rul. 61-72, 1961-1 C.B. 188; Rev. Rul. 64-231, 1964-2 C.B. 139. See Bromberg, "Tax Exemption of Homes for the Aged," 46 *Taxes* 68 (1968).

244. Rev. Rul. 72-124, 1972-1 C.B. 145.

245. The guidelines were subsequently published as Rev. Proc. 71-39, 1971-2 C.B. 575, and were amplified by Rev. Proc. 75-13, 1975-10 Int. Rev. Bull. – (announced in T.I.R. 1348, February 19, 1975).

246. *Senate Hearings on Tax Exemption*, op. cit.

247. Ibid.

248. 1975-10 Int. Rev. Bull. 7. The question of the charitable status of public interest law firms is discussed in the report to the Commission on Private Philanthropy and Public Needs on tax policy relating to environmental activities, which has been prepared by the firm of Reed Smith Shaw & McClay.

249. It should perhaps be noted that although the IRS chose not to base the charitable status of public interest law firms on the merits of the social goals which the firms seek to advance through litigation, such a rationale would also be an appropriate basis for exempting such firms under section 501(c) (3). It would, however, be a more difficult test for the IRS to administer.

250. Rev. Rul. 75-75, 1975-10 Int. Rev. Bull. 8.

251. Rev. Rul. 75-76, 1975-10 Int. Rev. Bull. 9.

252. A similar withdrawal by charity from an activity upon termination of the relevant community need was required in Rev. Rul. 73-313, op. cit.

253. An example of such a statute is The Legal Services Corporation Act of 1974, P.L. 93-355, 93rd Congress, 2nd Session, H.R. 7824 (July 25, 1974), which amends the Economic Opportunity Act of 1974 by adding a new Title X containing the following findings:

> Sec. 1001. The Congress finds and declares that –
>
> (1) there is a need to provide equal access to the system of justice in our Nation for individuals who seek redress of grievances;
>
> (2) there is a need to provide high quality legal assistance to those who would otherwise be unable to afford adequate legal counsel and to continue the vital legal services program.

This Act established The Legal Services Corporation and provided that it shall be eligible to be treated as an organization described in section 170(c) (2) (B) and section 501(c) (3) of the Internal Revenue Code. Another example is The Older Americans Act of 1965, P.L. 89-73, 89th Congress, 1st Session, 42 U.S.C. § 3001, which is cited in Rev. Rul. 72-124, op. cit., as the basis for a recognition of the special needs of older persons justifying a change in the charitable criteria regarding homes for the aged.

254. 347 U.S. 483 (1954). This case held that segregated state public schools are unconstitutional.

255. Restatement (Second) of Trusts § 374, Comment a, p. 257 (1957).

256. Ibid., at §374, Comment 1, p. 261.

257. 506 F.2d 1278 (D.C. Cir. 1974), *cert. granted*, 421 U.S. 975 (1975).

258. Rev. Rul. 56-185, 1956-1 C.B. 202.

259. Rev. Rul. 69-545, 1969-2 C.B. 117. In *Harding Hospital, Inc. v. United States*, 74-2 USTC 85,662 (6th Cir. 1974), the court held that a nonproprietary psychiatric hospital failed to qualify

under section 501(c) (3) on the basis of several factors, no one of which was singled out as crucial. These factors were (a) The hospital "did not hold itself out to the public in even a limited way as a charitable organization," and the only significant contributions it received were from the doctors who used its facilities to treat their patients; (b) the hospital did not have a specific plan or policy for the treatment of charity patients; (c) the doctors who organized the hospital had a "virtual monopoly" of the patients treated there and derived substantial benefits from the existence and operation of the hospital. The hospital could not qualify as charitable under the tests set forth in Rev. Rul. 69-545 because it did not operate an emergency room open to all persons. The court found it "unnecessary in the present case to pass judgment on the validity of Rev. Rul. 69-545."

260. Eastern Kentucky, 506 F.2d at 1288-9. The difficulty which is sometimes encountered in determining whether an organization is charitable is indicated by the separate opinion of Judge Wright (concurred in by Judge Bazelon) in the foregoing case. Judge Wright objected to the fact that although Rev. Rul. 69-545 "worked a substantial change in the availability of hospital services for the poor . . . neither the poor nor anyone else was given notice of the proposed change or allowed to comment on it." Ibid., p. 1291. He also stated that the decision of the majority affirming Rev. Rul. 69-545 was based upon "assumed social, economic and technological changes in the need of the poor for free medical care," and he contended that "[t]he record in this case does not reflect what the needs of the poor for free medical care really are . . ." 35 AFTR 2d 75-414, 415. He therefore argued that the rulemaking procedures of the Administrative Procedure Act should have been followed before the issuance of Rev. Rul. 69-545.

261. *Register of Wills of Baltimore County* v. *Cook*, 216 A.2d 542, 549 (1966).

262. This question is discussed hereafter in this report.

263. Rev. Rul. 69-572, 1969-2 C.B. 119, states that "[t]he performance of a particular activity that is not inherently charitable may nonetheless further a charitable purpose. The overall result in any given case is dependent on why and how that activity is actually being conducted."

264. Rev. Rul. 73-128, 1973-1 C.B. 222.

265. Rev. Rul. 71-580, 1971-2 C.B. 235, 236.

266. Rev. Rul. 68-655, 1968-2 C.B. 213.

267. 368 F. Supp. 863 (D.D.C. 1973).

268. Ibid., at 878. The IRS subsequently withdrew its appeal in this case and issued a ruling that the Center on Corporate Responsibility, Inc., qualifies under section 501(c) (3). However, the IRS announced that this action will not be considered a precedent to be followed in other cases. The IRS stated that it "is continuing to study issues of the type presented by this case with a view to providing additional guidance to taxpayers as to the principles governing such organizations and activities." T.I.R. 1277 (Feb. 21, 1974), 9 CCH 1974 Stand. Fed. Tax Rep., ¶ 6463. Thus far, no such additional guidance has been provided by the IRS.

269. IV Scott on Trusts §348, at 2767 (3d ed. 1967).

270. Reiling, "Federal Income Tax and Charity: Two Years of Regulations and Rulings," N.Y.U. 5th Biennial Conference on Charitable Foundations 245, 250 (1961).

271. Reg. §1.501(c) (3)–1(d) (1) (ii).

272. See, Reg. §53.4941(d)–2(f) (2) and (4), Example (4).

273. Rev. Rul. 70-533, 1970-2 C.B. 112, 113.

274. Rev. Rul. 70-186, 1970-1 C.B. 129.

275. Benedict Ginsberg, 46 T.C. 47 (1966).

276. Rev. Rul. 69-175, 1969-1 C.B. 149.

277. *Horace Heidt Foundation* v. *United States*, 170 F. Supp. 634 (Ct. Cl. 1959).

278. *Best Lock Corporation* v. *Commissioner*, 31 T.C. 1217 (1959).

279. 355 F.2d 269, 271 (3rd Cir. 1965).

280. William B. Chase, 19 T.C.M. 234, 250 (1960).

281. Tax Management Memorandum 73-22, p. 12 Tidbit 1 (BNA 1973).

282. While an administrative rule may be needed to deal with this problem, imposing a 25 percent limitation on the ratio of applications which may be approved seems unduly restrictive. For example, if a foundation sponsored by a large company adopted a scholarship program for talented children of employees with low incomes, there would appear to be little justification for requiring that 75 percent of the applicants be rejected.

283. In *Better Business Bureau* v. *United States*, 326 U.S. 279 (1945), the Supreme Court held that a business league was not exempt from the Social Security Act as an educational organization, referring to the fact that the organization was dedicated to the promotion of "mutual welfare, protection and improvement of business conditions among merchants."

284. Rev. Rul. 71-505, 1971-2 C.B. 232.

285. *Dulles* v. *Johnson*, 273 F.2d 362 (2d Cir. 1957); *St. Louis Union Trust Company* v. *United States*, 374 F.2d 427 (8th Cir. 1967).

286. *Hammerstein* v. *Kelley*, 349 F.2d 928 (8th Cir. 1965); Rev. Rul. 71-504, 1971-2 C.B. 231. See also, Rev. Rul. 74-553, 1974-2 C.B. 293, which holds that an organization established for the purpose of operating a system of "peer review boards" to maintain standards regarding the quality and costs of medical care is not charitable because its primary objective is to further the common business interests of the members. The organization was, however, ruled to be exempt as a business league under section 501(c) (6).

287. St. Louis Union Trust Company, op. cit., p. 440.

288. Rev. Rul. 61-72, op. cit.

289. The Exempt Organizations Handbook at 754.1(1) states that "[p]ractically, . . . a nonprofit school which does not distribute earnings to individuals, directly or indirectly, may be exempt under IRC 501(c) (3)." However, the IRS has ruled that a membership organization which performs seemingly "educational" functions for the benefit of its members (who are all users of a specific type of computer) is not exempt under section 501(c) (3). Rev. Rul. 74-116, 1974-1 C.B. 127. This organization is deemed to be serving the private interests of its members, rather than a public interest. On the other hand, an organization which conducts study courses for employees of banking institutions was held to be exempt under section 501(c) (3) as an educational organization. Rev. Rul. 68-504, 1968-2 C.B. 211. In the latter situation the study courses could be taken only by members of the organization, but membership was open to employees of all banks in the area. Also, credit was given by universities for such courses. These factors were apparently sufficient to prevent the organization from being regarded as one operated primarily for the private benefit of its members.

290. 1969-2 C.B. 117. This ruling was sustained in *Eastern Kentucky Welfare Rights Organization* v. *Simon*, op. cit. As noted earlier, prior to Rev. Rul. 69-545 the position of the IRS was that a hospital could qualify as charitable only if it was operated "to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."

291. Fulfillment of the requirement that 501(c) (3) hospitals make their services available on a community-wide basis is deemed to constitute an important benefit to the community by meeting the need of the public for health care. Rev. Rul. 69-545, op. cit.

292. Rev. Rul. 56-185, 1956-1 C.B. 202. See also, *Harding Hospital, Inc.* v. *United States*, op. cit., in which a hospital was denied exemption for the reason, among others, that it did not have a specific plan or policy for the treatment of charity cases.

293. Rev. Rul. 57-467, op. cit.; Rev. Rul. 61-72, op. cit., and Rev. Rul. 64-231, op. cit.

294. Rev. Rul. 72-124, op. cit. In another ruling, an organization formed and operated to provide low cost home nursing care on a nonprofit basis to the general public was held to be a charitable organization under section 501(c) (3) although the organization charged for its services. Any excess income was used to expand facilities and to cover the cost of providing services to patients who could not afford to pay. Rev. Rul. 72-209, 1972-1 C.B. 148.

295. Rev. Rul. 75-75, op. cit.; Rev. Rul. 75-76, op. cit.; Rev. Proc. 75-13, op. cit.

296. 1971-2 C.B. 234.

297. Rev. Rul. 69-528, 1969-2 C.B. 127.

298. 1973-1 C.B. 221.

299. Although organizations of this type have been in existence for many years, the enactment of the Health Maintenance Organization Act of 1973, P.L. 93-222, 93rd Congress, 2nd Session, could result in a significant increase in the role played by health maintenance organizations in meeting the health care needs of large segments of the community. For discussions of the role of health maintenance organizations see, Holley and Carlson, "The Legal Context for the Development of Health Maintenance Organizations," 24 *Stan. L. Rev.*644, 665-6 (1972); Schneider and Stern, "Health Maintenance Organizations and the Poor: Problems and Prospects," 70 *Nw. U.L. Rev.* 90 (1975); Note, "The Role of Prepaid Group Practice in Relieving the Medical Care Crisis," 84 *Harv. L. Rev.* 887 (1971) and Recent Developments, "Health Maintenance Organization Act of 1973," 27 *Vand. L. Rev.* 1943 (1974).

300. See, Holley and Carlson, op. cit. Due to the differing characteristics of the various types of organizations which provide prepaid health care services, the question of the tax status of health maintenance organizations is an extremely complex one.

301. Restatement (Second) of Trusts §377 (1957).

302. Ibid., at § 377, Comment c, at 267.

303. 1971-2 C.B. 230.

304. 330 F. Supp. 1150 (D.D.C. 1971).

305. Ibid., p. 1161.

306. 347 U.S. 483 (1954).

307. Rev. Rul. 71-447, op. cit. It is interesting to note that in Rev. Rul. 67-325, 1967-2 C.B. 113, the IRS denied exemption under section 501(c) (3) to an organization formed to operate a community recreational facility which excluded members of a particular race. The ruling was not based on the premise that such an exclusion is contrary to public policy but rather on the premise that under the general law of charity such an organization must make its facilities available to all membes of the community.

308. 338 F. Supp. 448 (D.D.C. 1972).

309. Ibid., pp. 459-60. The court's decision in the McGlotten case has been criticized on the grounds that fraternal orders should not necessarily be equated with schools and that there is a lack of "evidence that a fraternal order's racially restrictive membership rules violate public policy." Bittker and Kaufman, "Taxes and Civil Rights: 'Constitutionalizing' The Internal Revenue Code," 82 *Yale L.J.* 51, 76 (1972).

310. 496 F.2d 623 (2d Cir. 1973).

311. Ibid., p. 625.

312. Ibid., pp. 639-40.

313. It should be noted that the limitations regarding legislative and political activities may also raise constitutional questions under the First and Fifth Amendments when applied to organizations formed for nonreligious exempt purposes referred to in section 501(c) (3). Troyer, "Charities, Law-Making, and the Constitution: The Validity of the Restrictions on Influencing Legislation," *N.Y.U. 31st Annual Inst. on Fedl. Taxation* 1415 (1973).

314. *United States* v. *Seeger*, 380 U.S. 163, 174 (1965).

315. Ibid. The Seeger case involved the interpretation of language in the Universal Military Training and Service Act, 50 U.S.C. App. §456(j) (1968 ed.) which exempts from service in the Armed Forces of the United States those persons who by reason of their religious training and belief are conscientiously opposed to participation in war in any form.

316. Moore, Readings upon the Statute of 43 Elizabeth, contained in Duke, Law of Charitable Uses, 131, 132 (1676) cited in IV Scott on Trusts §371, n. 1, at 2880 (3d ed. 1967).

317. IV Scott on Trusts §371.4, at 2888 (3d ed. 1967).

318. The cases involving religious organizations under section 501(c) (3) do not usually confront the fundamental question of what constitutes "religion" but instead tend to turn upon secondary issues, such as whether engaging in publishing or commercial activities qualifies as a religious activity.

319. The Exempt Organizations Handbook, at 755.1(1), states: "The statutory term 'religion' has been defined broadly, following definitions developed in other areas of the law."

320. Bogert, op. cit., §376, at 142-3 (2d ed. 1964). The statement of Bogert, quoted in the text, was written before the Supreme Court's decision in *United States* v. *Seeger*, op. cit. This decision, which is discussed infra, appears to preclude a judicial evaluation of religious beliefs and practices. Also, in *Presbyterian Church* v. *Mary Elizabeth Blue Hull Memorial Presbyterian Church*, 393 U.S. 440 (1969), the Supreme Court held that civil courts cannot, consistently with the First Amendment, assess the importance and significance of changes in ecclesiastical doctrine for the purpose of resolving property disputes between differing religious groups.

321. IV Scott on Trusts §371.4, at 2888-9 (3d ed. 1967).

322. Webster's Third New International Dictionary 1918 (1966 ed.) defines religion as "the personal commitment to and serving of God or a god with worshipful devotion, conduct in accord with divine commands esp[ecially] as found in accepted sacred writings or declared by authoritative teachers, a way of life recognized as incumbent on true believers, and typically the relating of oneself to an organized body of believers."

323. *Davis* v. *Beason*, 133 U.S. 333, 342 (1890). This decision held that a statute of the Territory of Idaho, which forbade polygamists to vote and required voters to swear that they were not members of an order that advocated polygamy, did not violate the First Amendment rights of a member of the Mormon Church.

324. *United States* v. *Macintosh*, 283 U.S. 605, 633-4 (dissenting opinion) (1931); Overruled in *Girouard* v. *United States*, 328 U.S. 61 (1946).

325. 322 U.S. 78 (1944), rev'd. on other grounds, 329 U.S. 187 (1946).

326. Ibid., pp. 86-7. It may be noted that the religious nature of the "I Am" movement for purposes of section 501(c) (3) was upheld in St. Germain Foundation, 26 T.C. 648 (1956).

327. 249 F.2d 127 (D.C. Cir. 1957).

328. Ibid., p. 129.

329. 315 P.2d 395 (1957).

330. Ibid., p. 406.

331. 367 U.S. 488 (1961).

332. Ibid., p. 495.

333. Ibid., p. 495, n. 11.

334. 380 U.S. 163 (1965).

335. Ibid., p. 165.

336. Ibid., p. 184.

337. The Exempt Organizations Handbook states, at 755.1(3): "Recent Supreme Court decisions suggest that serious Constitutional difficulties would be presented if [section 501(c) (3)] were interpreted to exclude even those beliefs that do not encompass a Supreme Being in the conventional sense, such as Taoism, Buddhism, and Secular Humanism" (citing Seeger).

338. *Universal Life Church, Inc. v. United States*, 74-1 USTC 83,794 (E.D. Cal. 1974). "The Universal Life Church has no traditional doctrine. It only believes in that which is right. We believe that everyone has a right to his own conviction, a right to express it, and we recognize everyone's belief," Ibid., at 83,796.

339. Ibid., at 83,798. Despite the constitutional difficulties inherent in such an exercise, courts may be tempted to make an evaluation of the content of an asserted religious belief in an extreme case. For example, in *United States v. Kuch*, 288 F. Supp. 439 (D.D.C. 1968), the defendant sought to quash a criminal indictment which had been handed down against her for unlawful possession and sale of marihuana and LSD. The defendant contended that the indictment violated her religious liberties as a member of the Neo-American Church. This church (organized in 1965) adhered to the principle that psychedelic substances, such as LSD, are "sacramental foods" and that "it is the Religious duty of all members to partake of the sacraments on regular occasions." Ibid., p. 443. In declining to dismiss the indictment, the Court said that the church was not "a religion within the meaning of the First Amendment." Ibid., p. 445. The Court also held that even assuming "that the Neo-American Church is a genuine religion and that [defendant] subscribes fully to its doctrines and thus may invoke the full constitutional guarantees for free religious expression, her contentions are still without merit." Ibid., p. 445. This conclusion was based upon the premise that freedom of religion does not provide immunity from prosecution for conduct which is in violation of a criminal statute which has been validly enacted pursuant to the state's police powers.

340. This question was not raised in Seeger because the issue in that case was simply whether the claimants' opposition to serving in the armed forces was based upon their "religious training and belief."

341. 315 P.2d at 406.

342. Ibid., p. 406.

343. It has been suggested that "[t]he emphasis on a cultic bond and a body of established doctrine does not lend much encouragement to the undisciplined mystic who seeks unlimited license to escape, in any way he sees fit, into his own private world." Gianella, "Religious Liberty, Nonestablishment, and Doctrinal Development, Part I: The Religious Liberty Guarantee," 80 *Harv. L. Rev.*, 1381, 1430 (1967). However, such an individual could not qualify for exemption in any case because section 501 (c) (3) applies only to corporations, community chests, funds or foundations.

344. It is interesting to note that according to the regulations (Reg. §1.511-2(a) (3) (ii)) a religious organization apparently cannot qualify as a "church" unless it engages in the "ministration of sacerdotal functions and the conduct of religious worship." Prior to the Tax Reform Act of 1969 churches were wholly exempt from the tax on unrelated business income while other re-

ligious organizations which were not churches (or associations or conventions of churches) were subject to this tax. Under present law churches are accorded more favorable treatment than other religious organizations with respect to the filing of information returns (section 6033(a) (2)), examinations of their activities and books of account (section 7605(c)), and in other respects. E.g., sections 508(c) (1) (A) and 512(b) (16) of the Code.

345. Rev. Rul. 71-580, 1971-2 C.B. 235.

346. Rev. Rul. 74-575, 1974-2 C.B. 161.

347. 372 F. Supp. 770 (E.D. Cal. 1974).

348. Ibid., p. 776.

349. 41 T.C. 719 (1964).

350. Ibid., p. 728. It is interesting to note that in an earlier case involving the same organization and similar facts the Tax Court concluded that the committee, an agency of the Church, was not a religious organization and therefore contributions to it were not deductible since they were not for "the use of" an exempt charitable organization. Peggy Lou Riker 14 T.C.M. 903 (1955), aff'd. 244 F.2d 220 (9th Cir. 1957). In Golden Rule Church Association the Court distinguished the Riker decision on the grounds that in that case (1) an adequate record had not been made and (2) the constitutional issue had not been raised.

351. 22 T.C.M. 1435 (1963).

352. Ibid., p. 1444.

353. 41 T.C. at 729.

354. 372 F. Supp. at 776.

355. *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969). This case is interesting because the Court of Appeals for the District of Columbia had previously held that the same organization was not subject to certain provisions of the Food, Drug and Cosmetic Act because it was a bona fide religious organization. *Founding Church of Scientology v. United States*, 409 F.2d 1146 (D.C. Cir. 1969).

356. See, St. Germain Foundation, 26 T.C. 648 (1956); *Universal Life Church, Inc. v. United States*, 372 F. Supp. 770 (E.D. Cal. 1974); A.A. Allen Revivals, Inc., op cit., and *Universal Church of Scientific Truth, Inc. v. United States*, 32 AFTR 2d 73-6122 (N.D. Ala. 1973).

357. 22 T.C.M., op. cit., p. 1443.

358. Internal Revenue Code of 1954, §512.

359. Exempt Organizations Handbook, at 775.2(1).

360. A.A. Allen Revivals, Inc., op. cit.; St. Germain Foundation, op. cit., and Unity School of Christianity, 4 B.T.A. 61 (1926).

361. A.A. Allen Revivals, Inc., op. cit.

362. *Fides Publishers Association v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967) and *Scripture Press Foundation v. United States*, 285 F.2d 800 (Ct. Cl. 1961).

363. 263 F. Supp. at 935.

364. *Elisian Guild, Inc. v. United States*, 412 F.2d 121 (1st Cir. 1969).

365. Rev. Rul. 68-26, 1968-1 C.B. 272.

366. *Cf. Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).

367. Rev. Rul. 73-164, 1973-1 C.B. 223.

368. Exempt Organizations Handbook at 755.3.

369. Rev. Rul. 68-563, 1968-2 C.B. 212; cf. Rev. Rul. 66-220, 1966-2 C.B. 209 (organization operating radio station under noncommercial license from FCC may qualify for exemption as educational organization).

370. Tax Reform Act of 1969, section 121 amending section 512(a) and (b) (3)–(4) of the Internal Revenue Code. This change in the law was supported by the National Council of Churches and the Catholic Conference.

371. See Chapter II, p. 1929.

372. Reg. §1.501(c) (3)–1(c) (3) provides further guidance as to the manner in which the IRS interprets the statutory limitations on legislative and political activities.

373. Kelley, "When Religion Is Paid To Be Silent," *Worldview* 32 (April 1973; *House Comm. on Ways and Means*, 92nd Congress, 2nd Session, Statement of United States Catholic Conference on H.R. 13720 and Brief for NCCC as Amicus Curiae, *Christian Echoes National Ministry, Inc.* v. *United States*, 414 U.S. 864 (1973).

374. Reg. 45, Art. 517 (1918).

375. 42 F.2d 184 (2d Cir. 1930).

376. Ibid., p. 185.

377. Ibid.

378. Ibid.

379. Ibid.

380. 122 F.2d 108 (3d Cir. 1941).

381. Ibid., p. 110.

382. Ibid.

383. Ibid. The possible unconstitutionality of such a limitation was not commented upon by the court.

384. 65 F. Supp. 62 (E.D. Pa. 1946).

385. Ibid., p. 66.

386. *Christian Echoes National Ministry, Inc. v. United States*, 28 AFTR 2d 71-5934 (N.D. Okla. 1971), rev'd., 470 F.2d 849 (10th Cir., 1972), *cert. denied*, 414 U.S. 864 (1973).

387. Ibid., at 71-5935.

388. Ibid., at 71-5936.

389. 28 AFTR 2d 71-5934 (N.D. Okla. 1971).

390. Ibid., at 71-5945.

391. 470 F.2d 849, 854, 56-7 (10th Cir. 1972).

392. 414 U.S. 864 (1973).

393. 397 U.S. 664 (1970).

394. Ibid., pp. 668-9.

395. Ibid., pp. 669-70.

396. Ibid., p. 672.

397. Ibid., p. 674.

398. Ibid., p. 676. In reaching this conclusion, the Court relied heavily upon the long history of exemption of churches from taxation in the United States, which the Court noted had not led "to an established church or religion and on the contrary . . . has operated affirmatively to help guarantee the free exercise of all forms of religious belief." Ibid., p. 678. The Court in *Lemon v. Kurtzman*, 403 U.S. 602, 612-3 (1971) combined the test applied in Walz with earlier First Amendment decisions dealing with separation of Church and State (e.g., *Everson v. Board of Education*, 330 U.S. 1 (1947); *McCollum v. Board of Education*, 333 U.S. 203 (1948); *Zorach v. Clauson*, 343 U.S. 306 (1952); *McGowan v. Maryland*, 366 U.S. 420 (1961); *Torcaso v. Watkins*, 367 U.S. 488 (1961); *Engel v. Vitale*, 370 U.S. 421 (1962); *School District v. Schempp*, 374 U.S. 203 (1963); *Sherbert v. Verner*, 374 U.S. 398 (1963); *Board of Education v. Allen*, 392 U.S. 236 (1968) and *Epperson v. Arkansas*, 393 U.S. 97 (1968)) to supply a "three pronged test" of the Establishment Clause: "First, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion . . .; finally, the statute must not foster an excessive government entanglement with religion . . ."

399. Ibid., p. 695.

400. 358 U.S. 498 (1959).

401. Ibid., p. 513.

402. It should be noted that the principle of neutrality does not always require identical treatment of religious and secular organizations. For example, because of the unconstitutional "establishment" of religion which would result from governmental subsidy of religious schools, such schools have been denied governmental subsidies which are available to secular schools. E.g., *Lemon v. Kurtzman*, 403 U.S. 602 (1971). Conversely, in some circumstances the "free exercise" clause may require adherents of certain religious groups to be exempted from complying with laws enacted pursuant to the police power of a state, and binding on all others, where the state's interest in the enforcement of such laws against the religious adherents is not sufficient to warrant an infringement of their right to freely exercise their religion. E.g., *Wisconsin v. Yoder*, 406 U.S. 205 (1972) (Members of Amish religion relieved of duty to comply with state law requiring compulsory formal education of children beyond eighth grade.) Pfeffer, "The Supremacy of Free Exercise," 61 *Geo. L.J.* 1115 (19[illegible]). Accordingly, the wall of separation between church and state is "blurred, indistinct and variable . . . depending on all the circumstances of a particular relationship" *(Lemon v. Kurtzman, op. cit.*, at 614). Nevertheless, it would seem that a tax "subsidy" which encourages political division on religious lines is one of the principal evils that the first amendment sought to forestall. Cf., Freund, "Public Aid to Parochial Schools," 82 *Harv. L. Rev.* 1680, 1692 (1969).

403. The Christian Echoes case appears to be the only situation in which a court has ruled directly on this question. Other organizations have attempted to obtain judicial consideration of the question through the declaratory judgment or injunctive process but have been prevented from doing so on procedural grounds. See *Alexander v. Americans United for Separation of Church and State*, 416 U.S. 752 (1974).

404. See, Troyer, op. cit.; Clark, "The Limitation on Political Activities: A Discordant Note in the Law of Charities," 46 *Va. L. Rev.* 439 (1960) and Note, "Constitutional Aspects of Church Taxation," 9 *Colum. J. Law & Soc. Prob.* 646 (1973).

The constitutionality of the limitations on political (as distinguished from legislative) activity by 501(c) (3) organizations raises separate questions which are also extremely difficult. Before reaching such constitutional questions, it would first be necessary to determine whether participation in a political campaign is consistent with charitable status under the general law of charity. As noted in the text, under the general law of charity a charitable organization is not precluded from engaging in legislative activity which is in furtherance of its charitable objectives.

405. *Slee v. Commissioner*, op. cit., p. 185.

406. *Shelton v. Tucker*, 364 U.S. 479, 488 (1960).

407. Pending legislative proposals which would deal with some of these problems are discussed in the paper prepared for the Commission on Private Philanthropy and Public Needs by John B. Huffaker, "Legislative Activities of Charitable Organizations Other than Private Foundations, with Addendum on Legislative Activities of Private Foundations."

408. Bogert, op. cit., §375, at 130.

409. Bogert, op. cit., §375, at 115.

410. See, Reg. §1.501(c) (3)–1(d) (2).

411. Sacks, "The Role of Philanthropy: An Institutional View," 46 *Va. L. Rev.* 516, 530 (1960).

412. Reg. §1.501(c) (3)–1(d) (3) (i).

413. Reg. §1.501(c) (3)–1(d) (3) (ii).

414. Sacks, op. cit., p. 530.

415. Rev. Rul. 67-148, 1967-1 C.B. 132, 132-3. This statement was made in a ruling which granted exemption to an organization that presented public reenactments of Civil War battles, thereby educating both the participants and the observers concerning important historical events.

416. Rev. Rul. 66-178, 1966-1 C.B. 138.

417. Rev. Rul. 64-175, 1964-1 C.B. 185.

418. Rev. Rul. 64-174, 1964-1 C.B. 183.

419. Rev. Rul. 65-271, 1965-2 C.B. 161.

420. Rev. Rul. 66-46, 1966-1 C.B. 133.

421. Reg. §1.501(c) (3)–1(d) (3) (ii) Example (4).

422. Rev. Rul. 67-292, 1967-2 C.B. 184.

423. Rev. Rul. 67-216, 1967-2 C.B. 180.

424. Rev. Rul. 68-372, 1968-2 C.B. 205.

425. Rev. Rul. 66-103, 1966-1 C.B. 134. This ruling refers to the fact that section 117 of the Code, relating to scholarships and fellowships, recognizes that creative grants can properly be made by section 501(c) (3) organizations. The ruling does not specify whether such grants are educational or charitable (i.e., advancement of education).

426. Rev. Rul. 70-4, 1970-1 C.B. 126. While not qualifying under section 501(c) (3), this organization was regarded as being sufficiently beneficial to the community to qualify for exemption under section 501(c) (4).

427. Rev. Rul. 67-148, op. cit.

428. Rev. Rul. 69-384, 1969-2 C.B. 122.

429. See Rev. Rul. 70-4, op. cit. It is interesting to note that when participation in sports is combined with a substantial training or instructional purpose, the activity has been ruled to be educational. Rev. Rul. 65-2, 1965-1 C.B. 227 (teaching sports to children); Rev. Rul. 64-275, 1964-2 C.B. 142 (training candidates for Olympics in sail boat racing).

430. The same may also be true of scientific research, which has educational aspects while at the same time falling within the separate exempt category of "scientific purposes" under section 501 (c) (3). As discussed below, it is possible for activities that are not educational *per se* to be classified as educational when they are carried on by or under the control of an organization that is admittedly educational (or by or under the control of a group of such organizations). One example of such a situation is an interscholastic athletic association which is created and controlled by a group of accredited high schools. Rev. Rul. 55-587, 1955-2 C.B. 261. The IRS has held that such an organization is educational, although, as noted above, an amateur athletic association which has no affiliation with an established educational institution was denied exemption under section 501(c) (3). Rev. Rul. 69-384, op. cit.

431. Rev. Rul. 74-16, 1974-1 C.B. 126.

432. Rev. Rul. 65-298, 1965-2 C.B. 163.

433. Rev. Rul. 66-255, 1966-2 C.B. 210.

434. Rev. Rul. 68-504, 1968-2 C.B. 211.

435. Rev. Rul. 65-2, op. cit.; Rev. Rul. 64-275, 1964-2 C.B. 142.

436. Rev. Rul. 74-595, 1974-2 C.B. 164.

437. Rev. Rul. 73-569, 1973-2 C.B. 178.

438. Rev. Rul. 73-128, 1973-1 C.B. 272.

439. Rev. Rul. 70-640, 1970-2 C.B. 117.

440. Rev. Rul. 70-590, 1970-2 C.B. 116.

441. Rev. Rul. 68-71, 1968-1 C.B. 249.

442. Rev. Rul. 70-583, 1970-2 C.B. 114.

443. Rev. Rul. 72-101, 1972-1 C.B. 144.

444. Rev. Rul. 69-441, 1969-2 C.B. 115.

445. Rev. Rul. 68-164, 1968-1 C.B. 252.

446. Rev. Rul. 68-70, 1968-1 C.B. 248.

447. Rev. Rul. 68-14, 1968-1 C.B. 243.

448. Rev. Rul. 64-192, 1964-2 C.B. 136.

449. Rev. Rul. 66-258, 1966-2 C.B. 213, modifying Rev. Rul. 60-193, 1960-1 C.B. 195.

450. Rev. Rul. 74-615, 1974-2 C.B. 165.

451. Rev. Rul. 71-421, 1971-2 C.B. 229.

452. Rev. Rul. 71-421, op. cit., at 230.

453. Rev. Rul. 73-439, 1973-2 C.B. 176.

454. Rev. Rul. 68-72, 1968-1 C.B. 250.

455. Because of the presumption that they are "educational" *per se*, formal institutions of learning (such as colleges and secondary schools) are permitted to carry on ancillary activities that would not necessarily be recognized as "educational" for purposes of section 501(c) (3) when carried on by a separate organization having no such institutional ties. Thus, as has already been

noted, certain athletic activities which are commonly engaged in by schools and colleges are not regarded as "educational" if carried on by an independent organization. See note 430. In addition, certain publishing activities might lose their educational character if carried on by a separate organization outside the framework of a formal educational institution. See Rev. Rul. 63-235, 1963-2 C.B. 210; Rev. Rul. 67-4, 1967-1 C.B. 121; Rev. Rul. 66-104, 1966-1 C.B. 135; and Rev. Rul. 60-351, 1960-2 C.B. 169. The IRS has recognized that student participation in a political campaign is educational when done in connection with a college political science course. Rev. Rul. 72-512, 1972-2 C.B. 246. It is questionable whether such political activity would be recognized as educational in other circumstances. In spite of such rulings, the IRS has emphasized that "the fact that an activity is conducted through an educational institution [does not] necessarily give that activity an educational character." Rev. Rul. 60-193, op. cit., at 197; modified by Rev. Rul. 66-258, op. cit.

456. Reg. §1.501(c) (3)–1(d) (3) (ii), Examples (2) and (3). These techniques were used, either singly or in combination, by organizations held to be educational in the following rulings: Rev. Rul. 67-342, 1967-2 C.B. 187 (educational films); Rev. Rul. 66-256, 1966-2 C.B. 210 (public forums, debates, panels) and Rev. Rul. 66-220, 1966-2 C.B. 209 (radio).

457. Rev. Rul. 74-16, op. cit.; Rev. Rul. 72-228, 1972-1 C.B. 148 and Rev. Rul. 68-307, 1968-1 C.B. 258.

458. Rev. Rul. 75-196, 1975-22 Int. Rev. Bull. at 8.

459. Rev. Rul. 74-615, op. cit.; Rev. Rul. 71-506, 1971-2 C.B. 232; Rev. Rul. 70-79, 1970-1 C.B. 127 and Rev. Rul. 68-71, 1968-1 C.B. 249.

460. Rev. Rul. 72-560, 1972-2 C.B. 248.

461. Rev. Rul. 70-321, 1970-1 C.B. 129.

462. Rev. Rul. 67-342, 1967-2 C.B. 187.

463. Rev. Rul. 73-128, op. cit.

464. Rev. Rul. 70-534, 1970-2 C.B. 11[illegible]. The American Society of Travel Agents, Inc. has attempted unsuccessfully to enjoin the IRS from granting 501(c) (3) status to organizations which operate extensive travel programs for their members. *American Society of Travel Agents, Inc. v. Simon and Alexander*, 75-1 USTC 87,289 (Dist. Colo. 1975). The court held that the issue, as raised in the plaintiff's petition, was not justifiable.

465. Rev. Rul. 70-584, 1970-2 C.B. 114.

466. Rev. Rul. 72-512, op. cit.

467. Rev. Rul. 68-16, 1968-1 C.B. 246.

468. Rev. Rul. 67-392, 1967-2 C.B. 191.

469. Rev. Rul. 72-16, 1972-1 C.B. 143.

470. Rev. Rul. 70-590, op. cit.

471. Rev. Rul. 70-583, op. cit.

472. Rev. Rul. 69-441, op. cit.

473. Rev. Rul. 70-640, op. cit.

474. Rev. Rul. 73-569, op. cit. Counseling men regarding voluntary sterilization methods is also "educational." Rev. Rul. 74-595, op. cit.

475. Rev. Rul. 65-299, 1965-2 C.B. 165. In this ruling the organization was held to be exempt under section 501(c) (4) but not under section 501(c) (3). Compare with Rev. Rul. 69-441, op.

cit., in which the IRS held that a similar counseling program qualified under section 501(c) (3) when limited to poor people.

476. Sacks, op. cit., pp. 530-1.

477. See, for example Reg. 118, §39.101 (6) 1 (c), Fed. Reg. 5909 (September 26, 1953).

478. *Slee v. Commissioner*, 42 F.2d 184, 185 (2d Cir. 1930).

479. Reg. §1.501(c) (3)–(1) (d) (3) (i) (b).

480. The IRS has ruled that where an educational broadcasting station provides equal opportunities for all candidates for the same elective public office to express their views, and disclaims support for any particular candidate or viewpoint, the organization is carrying on an educational activity for purposes of section 501(c) (3) and is not an action organization. The ruling states that such an activity "furthers the education of the electorate by providing a public forum for the exchange of ideas and the debate of public issues which instructs them on subjects useful to the individual and beneficial to the community." Rev. Rul. 74-574, 1974-2 C.B. 160, 161.

481. See, for example, Friendly, "What's Fair on the Air," *New York Times Magazine*, March 30, 1975, p. 11, dealing with the constitutional and other legal problems that have arisen under the "fairness" doctrine as applied to TV and radio broadcasters by the Federal Communications Commission.

482. *Exempt Organizations Handbook* § 754.9(18). Consistent with this approach, in one of the few rulings under this regulation an organization was held not to be educational where it published information which discredited particular institutions and individuals on the basis of unsupported opinions and incomplete information about their affiliations. Rev. Rul. 68-263, 1968-1 C.B. 256.

483. Rev. Rul. 60-143, 1960-1 C.B. 192, 195.

484. Rev. Rul. 74-399, 1974-2 C.B. 172; Rev. Rul. 73-105, 1973-1 C.B. 264 and Rev. Rul. 73-104, 1973-1 C.B. 263.

485. Rev. Rul. 69-538, 1969-2 C.B. 116; Rev. Rul. 58-194, 1958-1 C.B. 240; *Squire v. Students Book Corp.*, 191 F.2d 1018 (9 Cir. 1951). Earlier cases reaching a contrary conclusion are no longer followed. *Stanford Univ. Book Store v. Helvering*, 83 F2d 710 (D.C. Cir. 1936); *Associated Students Store*, 9 P-H BTA Memorandum Decisions ¶42,132 (1942).

486. Rev. Rul. 67-217, 1967-2 C.B. 181.

487. Reg. §1.502-1(b).

488. Reg. §1.501(c) (3)–(1) (d) (1) (i) (f).

489. Bogert, op. cit., §375, at 124.

490. Rev. Rul. 60-143, op. cit. Prior to Rev. Rul. 60-143, the IRS took the position that an alumni association qualified under section 501(c) (3) only if it was controlled by the university. G.C.M. 22116, 1940-2 C.B. 100, revoked by Rev. Rul. 60-143, op. cit. See also, Rev. Rul. 56-486, 1956-2 C.B. 309 and *Estate of Thayer*, 24 T.C. 384, acq. 1956-2 C.B. 8.

491. Rev. Rul. 67-291, 1967-2 C.B. 184. It is interesting to note that the IRS makes a distinction between the feeding of college athletes and the recruitment of such athletes. The latter activity is not exempt under section 501(c) (3) when carried on by an organization that is not an integral part of the university. Rev. Rul. 56-13, 1956-1 C.B. 198.

492. Rev. Rul. 71-529, 1971-2 C.B. 234. This ruling was not expressly based upon the advancement of education rationale, but seems to be a clear illustration of the principle.

493. Bogert, op. cit., §375, at 122-3.

494. Rev. Rul. 69-257, 1969-1 C.B. 151. This ruling makes clear that scholarships may be awarded on the basis of scholastic ability rather than need.

495. Rev. Rul. 63-220, 1963-2 C.B. 208; Rev. Rul. 61-87, 1961-1 C.B. 191.

496. Rev. Rul. 71-97, 1971-1 C.B. 150.

497. Bogert, op. cit., §375, at 129.

498. Rev. Rul. 69-257, op. cit.

499. Reg. §1.502-1(b).

500. Rev. Rul. 74-146, 1974-1 C.B. 129.

501. Rev. Rul. 74-614, 1974-2 C.B. 164.

502. Reg. §1.502-1(b).

503. *American Academy of Arts and Sciences v. Harvard College*, 12 Gray (Mass.) 582, 594 (1832).

504. *In re Sutro's Estate*, 102 P. 920, 923-4 (Sup. Ct. of Cal. 1909).

505. Reg. §1.501(c) (3)–1(d) (5). The regulations point out that for purposes of the exclusion from unrelated business taxable income provided by section 512(b) (9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on "fundamental," as contrasted with "applied," research.

506. A proposed regulation that would have denied exemption to "applied or product research" under section 501(c) (3) was published by the IRS in 1959. Prop. Reg. §1.501(c) (3)–1(d) (3) (ii), Example (5), Fed Reg. Feb. 26, 1959, p. 1423. This proposed regulation was not adopted.

507. Reg. §1.501(c) (3)–1(d) (5) (ii).

508. Gray, "What is 'Research' for Purposes of Exemption," *5th Biennial N.Y.U. Conference on Charitable Foundations* 233 (1961).

509. Rev. Rul. 68-373, 1968-2 C.B. 206.

510. Ibid.

511. Rev. Rul. 65-1, 1965-1 C.B. 226.

512. Ibid.

513. In such a situation the organization would not itself be carrying on a commercial operation, since it would derive no income from its research activities. Nor would it be directed toward benefiting particular manufacturers through exclusive licensing arrangements, since the results of its research would be freely available to the public. However, making the research results available to the public on a royalty-free basis would not enable an organization to qualify under section 501(c) (3) if the research projects are selected by the members of the organization for the purpose of creating new sales or markets for their products. Rev. Rul. 69-632, 1969-2 C.B. 120.

514. These rules are contained in Reg. §1.501(c) (3)–1(d) (5) (iii).

515. Ibid.

516. Ibid.

517. Rev. Rul. 65-1, op. cit.

518. Gray, *op. cit.*, at 243. Even where a research organization makes its research results freely available to the public, it will not be exempt under section 501(c) (3) if it performs research only for persons that are directly or indirectly its creators and that are not described in section 501(c) (3). Reg. §1.501(c) (3)–1(d) (5) (iv) (a). The same is also true where the persons who control the organization and select the research projects which it will undertake do so with a view to advancing their own private business interests. Rev. Rul. 69-632, op. cit. In both of these situations the fact that the research results are made freely available to the public is immaterial because the research activities are "tainted" with a private interest from their inception.

519. Reg. §1.501(c) (3)–1(d) (5) (iii) (c).

520. Reg. §1.501(c) (3)–1(d) (5) (iii) (c) (1). Although the situation seems less likely to arise, it is conceivable that scientific research might be carried on for the purpose of aiding in the scientific education of *secondary* school students. In such a case the research would seem to qualify under section 501(c) (3) because of its educational purpose, notwithstanding the fact that it is not specifically included in the examples set forth in the regulations cited above.

521. Reg. §1.501(c) (3)–1(d) (5) (iii) (c) (2).

522. Reg. §1.501(c) (3)–1(d) (5) (iii) (c) (3). It seems likely that this example would also cover scientific research carried on for the purpose of discovering a means of preventing a disease or of alleviating the harmful effects of a disease.

523. Reg. §1.501(c) (3)–1(d) (5) (iii) (c) (4).

524. It seems clear from the language of the regulations that the four examples set forth in Reg. §1.501(c) (3)–1(d) (5) (iii) (c) (4) are illustrative only and are not intended to be all inclusive.

525. Sacks, "The Role of Philanthropy: An Institutional View," 46 *Va. L. Rev.* 516, 528 (1960).

526. Reg. §1.501(c) (3)–1(d) (5) (iii) (b) and (c) and (iv) (b).

527. See discussion in charitable section of this report.

528. Reg. §1.501(c) (3)–1(d) (5) (iv) (a).

529. See, for example, Rev. Rul. 69-632, op. cit. This problem does not exist if the creators of the research organization are themselves exempt under section 501(c) (3).

530. Reg. §1.501(c) (3)–1(d) (5) (iv) (b).

531. Reg. §1.501(c) (3)–1(d) (5) (iv) (b).

532. Rev. Rul. 65-60, 1965-1 C.B. 231.

533. See, Chapter II.

534. Rev. Rul. 65-60, op. cit. (research in the social sciences), *Faulkner v. Commissioner*, 112 F.2d 987 (1st Cir. 1940) (Contributions to Birth Control League for dissemination of contraceptive advice held charitable in part on the basis activities were "scientific") and *Dulles v. Johnson*, 273 F.2d 362 (2d Cir. 1959) (Research activities of a bar association, in part held "scientific.")

535. See, Randolph, "What Bars Should Consider in Prepaid Legal Services Plans," 60 *Amer. Bar Ass. J.* 797 (July 1974). Although this article indicates that the organization which operated the pilot project was exempt as a charitable organization, it is understood that the IRS actually based its conclusion on the scientific rationale.

536. Rev. Rul. 66-147, 1966-1 C.B. 137, Rev. Rul. 67-4, 1967-1 C.B. 121, Rev. Rul. 70-129, 1970-1 C.B. 128 and *Science and Research Foundations, Inc. v. U.S.*, 5 AFTR 2d 646 (S.D. Ill. 1960).

537. Revenue Act of 1918, Ch. 18, § 231(b), 40 Stat. 1076 (1918). The same statute also added the "prevention of cruelty to animals" to the list of exempt purposes.

538. 247 U.S. 251 (1918).

539. 247 U.S. at 275. Notwithstanding the majority's recognition of the need for legislation to limit the employment of children in hazardous occupations, the law which Congress enacted to deal with this problem at the federal level was held by the majority to be unconstitutional in *Hammer* v. *Dagenhart* as an invalid exercise of the power of Congress to regulate interstate commerce. However, the rationale of the Supreme Court's decision in *Hammer* v. *Dagenhart* was subsequently overruled in *United States* v. *Darby*, 312 U.S. 100 (1941).

540. Restatement of Trusts 2d § 372a.

541. Rev. Rul. 67-151, 1967-1 C.B. 134.

542. Revenue Act of 1918, Ch. 18, § 231(b), 40 Stat. 1076 (1918).

543. See discussion in Bogert, op. cit., § 379 at 188, IV Scott on Trusts § 374.2, at 2905; Restatement (Second) of Trusts § 374; In re Hamilton's Will, 185 Misc. 660, 57 N.Y.S.2d 359 (1945), aff'd, 270 A.D. 634, 63 N.Y.S.2d 265 (1946), aff'd, 296 N.Y. 578 (1946).

544. Rev. Rul. 66-359, 1966-2 C.B. 219.

545. Rev. Rul. 74-194, 1974-1 C.B. 129.

546. Rev. Rul. 71-421, 1971-2 C.B. 229.

547. Rev. Rul. 67-293, 1967-2 C.B. 185.

548. Revenue Act of 1921, Ch. 136, 42 Stat. 227 (1921).

549. See Weithorn, 1 *Tax Techniques for Foundations and Other Exempt Organizations*, § 6.08; Trenerry, "A Literary Pilgrim's Progress Along Section 501(c) (3)," *51 A.B.A. Journal* 252 (1965); Edith L. Fisch, Doris J. Freed and Esther R. Schachter, *Charities and Charitable Foundations*, op. cit., p. 667. It should also be noted that the Exempt Organizations Handbook does not discuss organizations engaged in literary and publishing activities as a separate category of exempt organizations. Rather all discussions of such organizations is included within the discussions of educational and religious organizations.

550. 1961-1 C.B. 121.

551. Rev. Rul. 66-147, 1966-1 C.B. 137.

552. Rev. Rul. 66-147, op cit.

553. Rev. Rul. 67-4, 1967-1 C.B. 121.

554. Rev. Rul. 60-351, 1960-2 C.B. 169.

555. Rev. Rul. 66-104, 1966-1 C.B. 135.

556. The income tax deduction for "charitable contributions" provided by section 170 is, insofar as relevant, limited to contributions to organizations "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals." Section 170(c) (2) (B). See also, sections 2055, 2106 and 2522.

557. *Underwriters' Laboratories, Inc.* v. *Commissioner*, 135 F.2d 371 (1943), *cert. denied*, 320 U.S. 756 (1943).

558. Internal Revenue Service Handbook, section 758(2).

559. Reg. §1.501(c) (3)-1(d) (4).

560. Rev. Rul. 65-61, 1965-1 C.B. 234.

561. Rev. Rul. 68-373, 1968-2 C.B. 206.

562. Rev. Rul. 65-61, op cit.

563. Section 513(c) defines a "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services."

564. 263 U.S. 578 (1924).

565. Ibid., p. 581.

566. *Commisioner* v. *Edward Orton, Jr..*, Ceramic Foundation, 173 F.2d 483 (6th Cir. 1949); *Debs Memorial Radio Fund* v. *Commissioner*, 148 F.2d 948 (2d Cir. 1945); *Bohemian Gymnastic Ass'n* v. *Higgins*, 147 F.2d 774 (2d Cir. 1945); *Southeastern Fair Association* v *U.S.*, 52 F. Supp. 219 (Ct. Cl. 1943). See Norman A. Sugarman and Harlan Pomeroy, "Business Income of Exempt Organizations," 46 *Va. L. Rev.* 424, 428 (1960).

567. *Roche's Beach, Inc.* v. *Commissioner*, 96 F.2d 776 (2d Cir. 1938); *Willingham* v. *Home Oil Mill*, 181 F.2d 9 (5th Cir. 1950), *cert. denied*, 340 U.S. 852 (1950); *C.F. Mueller Co.* v. *Commissioner*, 190 F.2d 120 (3d Cir. 1951). However, some courts rejected the exemption of "feeder organizations." *United States* v. *Community Services, Inc.*, 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1951); *Ralph H. Eaton Foundation* v. *Commissioner*, 219 F.2d 527 (9th Cir. 1955); C.F. Mueller Co., 14 TC 922 (1950), rev'd, 190 F.2d 120 (3d Cir. 1951).

568. Historical development of the problem has been described as follows:

> Prior to 1940 the problem of charity in business was more academic than significant from a revenue standpoint: The complained of activities were not very widespread, the tax rates were low, and most philanthropy was carried on by public or quasi-public institutions.
>
> World War II changed this picture as tax rates rose and money became more plentiful. These two factors combined to intensify the populace's interest in philanthropy. This interest was manifested in the burgeoning numbers of family foundations; small charitable receptacles over which the Government had almost no control. The Service's interest in the area also grew; the increased tax rates had increased the extent to which the Government was underwriting charity in this country. (Kenneth C. Eliasberg, "Charity and Commerce: Section 501(c) (3)--How Much Unrelated Business Activity?" 21 *Tax Law Rev.* 53, 74 (1965).)

569. Imposition of what is now the unrelated business income tax was first suggested by the the Treasury Department in 1942. At that time, it was stated that many exempt organizations had "so far departed from the purpose of the exemption as to engage in trades and businesses completely unrelated to their exempt activities." *Hearings on Revenue Revision Before House Committee on Ways and Means*, 77th Congress, 2d Session 89 (1942). Prior to the Tax Reform Act of 1969, churches and conventions and associations of churches were not subject to the tax.

570. The Act also contained provisions denying exemption to many 501(c) (3) organizations which engaged in "prohibited transactions" or accumulated unreasonably large amounts of income. These provisions were either revoked or amended by the Tax Reform Act of 1969 in regard to their application to 501(c) (3) organizations, and were replaced by provisions imposing taxes on private foundations which engaged in such activities. A discussion of the restrictions imposed on the business activities of private foundations is beyond the scope of this paper.

571. H. R. Rep. No. 2319, 81st Congress, 2d Session (1950), 1950-2 C.B. 380, 409, 412; S. Rep. No. 2375, 81st Congress, 2d Session (1950), 1950-2 C.B. 483, 504, 509.

572. S. Rep. No. 2375, 81st Congress, 2d Session (1950), 1950-2 C.B. 483, 504-505.

573. S. Rep. No. 2375, 81st Congress, 2d Session (1950), 1950-2 C.B. 483, 505.

574. The tax also applies to every organization exempt from tax under section 501(a) except for certain corporations organized under Act of Congress. Sections 511(a), (b) and (c).

575. Section 512 defines the term "unrelated business taxable income," providing exclusions therefrom for passive income such as dividends, interest, annuities, royalties, most rents from real property and most capital gains. However, under certain circumstances rents from personal prop-

erty and passive income from "debt-financed" property will be included in unrelated business taxable income.

576. The requirement that the trade or business be regularly carried on is not mentioned in the text of section 513 but is incorporated in Reg. §1.513-1(c). It should be noted that section 513(a) excludes several trades or businesses from the definition of unrelated trade or business, including thrift shops, businesses conducted by volunteers, and businesses carried on primarily for the convenience of a 501(c) (3) organization's members, students, patients, officers, or employees.

577. Sec. 513(c). See also Reg. §1.513-1(b) which provides "...for the purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."

578. Reg. §1.513-1(b).

579. "In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162 – and which, in addition, is not substantially related to the performance of exempt functions – presents sufficient likelihood of unfair competition to be within the policy of the tax." Reg. §1.513-1(b).

Courts often emphasize the element of competition when they cannot distinguish the activities of an organization claiming 501(c) (3) status from those of commercial firms with which it competes. See, e.g., *Scripture Press Foundation* v. *United States*, 285 F.2d 800 (Ct. Cl. 1961), *cert. denied*, 368 U.S. 985 (1962). They have also upheld exemption where no competitive advantage is derived from exempt status. See, e.g., Forest Press, Inc., 22 T.C. 265 (1954); Edward Orton, Jr., Ceramic Foundation, 56 T.C. 147 (1971), *acq.* 1972-2 C.B. 2 *non acq.* 1972-2 C.B. 4. For a discussion of the competitive factor in resolving difficult cases, see "Preventing the Operation of Untaxed Business By Tax Exempt Organizations," 32 *U. Chi. L.* Rev. 581 (1965).

580. Section 513(c).

581. Reg. §1.513-1(b).

582. Ibid. In a recent decision it was held that the publication of commercial advertisements in a journal published by a 501(c) (6) organization was not an unrelated trade or business for years beginning before January 1, 1970, (the effective date of existing section 513(c)), and the Treasury regulations to the contrary were held to be an impermissible enlargement of the statutory provisions under which they were promulgated. *Massachusetts Medical Society* v. *United States*, 514 F.2d 153 (1st Cir. 1975).

583. Reg. §1.513-1(c) (1).

584. Reg. §1.513-1(c) (2) (i).

585. Reg. §1.513-1(c) (2) (ii). For years beginning prior to December 13, 1967, a stricter standard was applied under which a trade or business was treated as regularly carried on when the activity, even though performed infrequently, was conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. Reg. §1.513-2(a) (3); Exempt Organizations Handbook, §(27)33.2; T.I.R. No. 899 (April 14, 1967), reported at 7 CCH 1967 Stand. Fed. Tax Rep. ¶6557.

586. Reg. §1.513-1(d) (1).

587. Reg. §1.513-1(d) (2).

588. The tests of substantial relationship discussed in the text were adopted in 1967 as a result of a comprehensive IRS study of the "fundamental legal concepts of the tax [including the conceptual distinction between 'related' and 'unrelated' business activities] and their bearing upon commonly encountered fact patterns." For a discussion of the objectives of the study and some of the problems considered, see Mitchell Rogovin, "Tax Exemption: Current Thinking Within the Service," 22 NYU Inst. on Fed. Tax 945 (1965).

The regulations adopted in 1967 were intended to "accord full weight to the basic Congressional purpose – repeatedly emphasized in the legislative history of the 1950 Act – to remove the unfair competitive advantage which tax immunity would confer upon exempt organization businesses." T.I.R. No. 899 (April 14, 1967), reported at 7 CCH 1967 Stand. Fed. Tax Reports ¶6557. One of the more important liberalizations of the 1967 regulations was the adoption of the "contribute importantly" test of substantial relationship, in place of a test under which a business would not be considered substantially related unless its "principal purpose" was the furtherance of exempt functions. See Reg. §1.513-2(a) (4). It has been suggested that in some respects the 1967 regulations do not represent a liberalization because some activities, such as the publication of advertising in an exempt organization's journal, will be treated as unrelated businesses under the "contribute importantly" rule, whereas they were not taxable under the former "principal purpose" test. See Stanley Weithorn, *1 Tax Techniques for Foundations and Other Exempt Organizations*, §41.01[2] (1974).

589. Reg. §1.513-1(d) (4) (i), Example 1.

590. If the product resulting from the exempt function is substantially altered prior to sale, the income will be treated as income from the conduct of an unrelated trade or business. Reg. §1.513-1(d) (4) (ii).

591. Reg. §1.513-1(d) (3). See also, Reg. §1.513-1(d) (4) (iii) which provides that if an asset or facility necessary to the conduct of exempt functions is also employed in an unrelated commercial endeavor, the income from such operation will be income from the conduct of an unrelated trade or business.

592. Competition with commercial enterprises is an important factor in determining whether a business activity is "unrelated" to exempt purposes. However, several rulings indicate that an organization whose primary activity is the conduct of a business which competes with taxable businesses will not be denied exemption if the business activity is an integral part of and essential to the achievement of the organization's exempt purposes. See, e.g., Rev. Rul. 73-128, 1973-1 C.B. 222, granting exemption to an organization which provides on-the-job training to unemployed persons with respect to the manufacture and sale of toy products on the theory that the manufacturing and merchandising operation is a direct means of accomplishing the organization's charitable and educational objectives of providing vocational training to the unskilled. Compare Rev. Rul. 73-127, 1973-1 C.B. 221, denying exemption to a nonprofit organization which operates a retail grocery outlet to provide food at low cost to residents of a poverty area and allocates a small portion of its earnings for use in a training program for the unemployed persons in various jobs in the store. The operation of the store and the training program were treated as two distinct purposes and the former was not recognized as charitable. For a discussion of this problem as it applies to local economic development corporations, see Howard M. Weinman, "New Opportunities Opening Up For 501(c) (3) Organizations To Assist Profitable Businesses," 41 *J. Taxation* 102 (August, 1974).

593. 1969-1 C.B. 160.

594. The same type of analysis appears to have been used in Rev. Rul. 69-268, 1969-1 C.B. 160 (operation of cafeteria and coffee shop by 501 (c) (3) hospital for use by employees and visitors improves hospital's efficiency and encourages longer visits to patients, and is therefore substantially related to exempt purpose of providing health care to members of the community); Rev. Rul. 69-269, 1969-1 C.B. 160 (operation of parking lot for patients and visitors by 501(c) (3) hospital encourages visitation of patients and is substantially related to exempt purpose); Rev. Rul. 74-399, 1974-33 I.R.B. 14 (operation of dining room, cafeteria and snack bar by exempt art museum enables visitors to spend more time at museum and therefore contributes importantly to its exempt purposes).

595. 1973-1 C.B. 263.

596. 1973-1 C.B. 264.

597. For other examples of situations in which the causal relationship between business activities and exempt purposes was not sufficiently strong to be substantially related, see Rev. Rul. 72-431, 1972-2 C.B. 281 (sale of mailing lists by exempt organization to facilitate mailing of commercial advertising to members does not contribute importantly to exempt purpose); Rev. Rul. 69-69,

1969-1 C.B. 159 (rental of apartments to artists and operation of dining hall for their use does not contribute importantly to accomplishing exempt purposes of organization formed to stimulate and foster public interest in fine arts); Rev. Rul. 66-323, 1966-2 C.B. 216 (sale of blood and blood products to commercial laboratories by exempt blood bank formed to provide a community with permanent facilities for collection, storage and distribution of blood, is not substantially related to exempt purposes); Rev. Rul. 57-313, 1957-2 C.B. 316 (operation of medical illustration department and electroencephalography clinic in manner similar to a commercial undertaking is unrelated to exempt purposes of a medical and scientific research organization).

598. Reg. §1.501(c) (3)-1(b) (1) (i) (b).

599. Reg. §1.501(c) (3)-1(c) (1). While a 501(c) (3) organization may conduct insubstantial business activities without jeopardizing its exempt status, if it is a private foundation it may be subject to the tax on excess business holdings under section 4943.

600. The complete test of this regulation is as follows: "An organization may meet the requirements of section 501(c) (3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes." Reg. §1.501(c) (3)-1(e).

601. See Sugarman and Pomeroy, op. cit., note 4 at 434, in which the argument is made that Reg. §1.501(c) (3)-1(e) (1) must be interpreted to mean that an exempt organization may have substantial business activities, whether related or unrelated under section 513, with the exemption to be ultimately determined by the primary purpose of the organization.

For a discussion of the proposition that unrelated business activities should be disregarded for purposes of determining whether an organization is entitled to exemption under section 501(c) (3), see Eliasberg, op. cit., note 568 and Rogovin, op. cit., note 588.

> If the organization, when so regarded, complies with the requirements of Section 501(c) (3), the Service should seek to tax the unrelated activity under Section 511 and not challenge the underlying exempt status. If on the other hand, the organization is engaged in no activity other than those complained of and claims exemption solely because the profits from the commercial activities are payable to some organizations described in Section 501(c) (3) then it would be a "feeder" within the meaning of Section 502 and not entitled to exemption. Rogovin, op. cit., note 588 at 959.

602. S. Rep. No. 2375, 81st Congress, 2d Session, 28-9 (1950), 1950-2 C.B. 483, 504-5.

603. If a subsidiary is organized for the exclusive purpose of holding title to property and turning over the net income that it collects from such property to a 501(c) (3) organization, it is exempt from tax under section 501(c) (2).

604. It has been argued that the Revenue Act of 1950 did not reject the destination of income test in its entirety, but that section 502 was "designed to deal with the limited case of an organization all of whose income was attributable to the conduct of a business and whose exclusive nexus with the applicable exemption provision was the fact that it was obliged to transfer such income to a specific organization or group of organizations described therein." Eliasberg, op. cit., note 568 at 82 et seq. (1965).

605. Exempt Organizations Handbook, at (25)41.1.

606. Reg. §1.502-1(b). An organization closely affiliated with and formed to assist an exempt organization perform its exempt functions will similarly be granted exemption, even if it is not created or controlled by the exempt operating organization. For illustrations of organizations that are exempt because their activities further the exempt purposes of another exempt organization, see Rev. Rul. 69-538, 1969-2 C.B. 116 and Rev. Rul. 58-194, 1958-1 C.B. 240 (book and supply store for convenience of university students and faculty); Rev. Rul. 67-217, 1967-2 C.B. 181 (organization that provides housing and food services for university students and faculty); Rev.

Rul. 68-16, 1968-1 C.B. 246 (fund set up as adjunct to school of business administration for sole purpose of providing business students with instruction and experience in security portfolio management).

607. A fortiori, if an unrelated business activity possesses no exempt characteristics when performed by a 501(c)(3) organization, it cannot acquire them simply by being transferred to a subsidiary. See, e.g., Rev. Rul. 69-177, 1969-1 C.B. 150, where a subsidiary of a 501(c) (3) college manufactured and sold wood and metal products for the principal purpose of furnishing employment to students to enable them to continue their education. The subsidiary was denied exemption under section 502 on the theory that the business was not an educational activity because the students were not employed for the purpose of receiving instruction or training or improving capabilities. See, Rev. Rul. 73-164, 1973-1 C.B. 223, denying exemption under section 502 to a church controlled commercial printing corporation whose business earnings are paid to church but which performs no other significant charitable activity.

608. Section 502(b) (1). Prior to the Tax Reform Act of 1969, the exception applied to "the rental by an organization of its real property (including personal property leased with the real property)." Under the protection of this provision organizations which paid their rental profits over to universities and other 501(c) (3) institutions were able to acquire businesses and generate income by trading on their tax exemptions. Typically, such organizations would acquire operating businesses with little or no down payment and without personal liability and then lease the assets back to the original owners or to other persons using the tax exempt rental payments to pay off the purchase price. However, in 1971 the Ninth Circuit held that an organization which participated in many such transactions was not protected by the rental exception and was engaged in a trade or business for profit. *University Hill Foundation* v. *Commissioner*, 446 F.2d 701 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972).

609. Section 502(b) (2); Rev. Rul. 71-581, 1971-2 C.B. 236.

610. Section 502(b) (3).

611. Reg. §1.502-1(b) provides, in part: ". . . if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. . ."

612. 1954-2 C.B. 127.

613. 158 F. Supp. 560 (Ct. Cl. 1958).

614. Ibid., p. 564. The court also made an interesting argument that the predecessor of Reg. §1.502-1(b), which denied exemption to an organization owned by several unrelated exempt organizations, did not apply to the service organization under consideration because all its members were 501(c) (3) hospitals, and therefore engaged in "related charitable activities." As a result of the decision in Hospital Bureau of Standards and Supplies, Inc., Reg. §1.502-1(b) was amended to provide that

> "For purposes of this paragraph, organizations are related only if they consist of –
>
> (1) A parent organization and one or more of its subsidiary organizations; or
>
> (2) Subsidiary organizations having a common parent organization.
>
> An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities." T.D. 6662, 1963-2 C.B. 214, 216.

615. Section 501(e) was enacted in section 109 of the Revenue and Expenditure Control Act of 1968, P.L. 90-364.

616. Section 501(e) (1); see Conference Report No. 1533, 90th Congress, 2d Session, 1968-2 C.B. 801 at 814; Statement by the Hon. George A. Smathers In Explanation of the Conference

Report, June 21, 1968, 114 Cong. Record S. 7480, reported at 2 *U.S. Code Cong. & Admin. News*, 90th Congress, 2d Session 2422, 2427 (1968).

617. Section 501(e) (2).

618. Rev. Rul. 69-160, 1969-1 C.B. 147; Rev. Rul. 69-633, 1969-2 C.B. 121.

619. Rev. Rul. 69-160, 1969-1 C.B. 147. However, if all of the net earnings derived by the service organization from dealings with patrons are distributed or allocated pursuant to a preexisting obligation to the patron hospitals within the time and manner prescribed for cooperative organizations in sections 1381 through 1383, the service organization would have no taxable income from such dealings. Rev. Rul. 69-633, 1969-2 C.B. 121.

620. 384 F. Supp. 776 (S.D. Ind. 1974).

621. Ibid., p. 782.

622. 9 CCH 1975 Stand. Fed. Tax Rep. 70,738 (June 18, 1975).

623. S. Rep. No. 93-888, 93rd Congress, 2d Session (1974), as reported at 2 *U.S. Code Cong. & Admin. News*, 93rd Congress, 2d Session 3266, 3267 (1947).

624. Ibid. The ruling was published as Rev. Rul. 71-529, 1971-2 C.B. 234, which stated that in providing its 501(c) (3) members with investment management services and obtaining contributions to cover part of the management costs, the organization was performing an essential function for them, and by charging only a nominal fee for such services, it was performing a charitable activity within the meaning of section 501(c) (3). Compare Rev. Rul. 69-528, 1969-2 C.B. 127, concerning an organization which was formed to provide investment services on a fee basis exclusively to 501(c) (3) organizations and is free from control by the participants. The organization was denied exemption under section 502 on the theory that the provision of investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit which would be an unrelated trade or business if carried on by any of the 501(c) (3) organizations on whose behalf it operated.

625. See, Rev. Rul. 72-369, 1972-2 C.B. 245, where an organization formed to provide managerial and consulting services such as writing job descriptions and training manuals, recruiting personnel, constructing organizational charts, and advising on methods of operation, at cost to "unrelated" 501(c) (3) organizations, was denied exemption. "An organization is not exempt merely because its operations are not conducted for the purpose of producing a profit . . . Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable."

Rev. Rul. 71-529, op. cit., note 624 was distinguished because the service organization there was controlled by a group of 501(c) (3) organizations and charged them substantially less than cost for its services.

626. S. Rep. No. 93-888, 93rd Congress, 2d Session (1974), reported at 2 *U.S. Code Cong. & Admin. News*, 93rd Congress, 2d Session 3266, 3267-8 (1974).

627. The legislative history indicates that school investment funds, qualifying under section 501(c) (3) but organized separately from the particular college for the benefit of which it operates, could participate in the cooperative investment organization on the same basis as the school itself, unless they represent private foundations. An example of such a fund is a foundation that operates as an arm of a State college or university and is recognized as a "public charity" under section 170(b) (1) (A) (iv). S. Rep. No. 93-888, 93rd Congress, 2d Session (1974), reported at 2 *U.S. Code Cong. & Admin. News*, 93rd Congress, 2d Session 3266, 3268 (1974).

628. Section 501(f), enacted by P.L. 93-310, is effective for taxable years ending after December 31, 1973.

629. S. Rep. No. 93-888, 93rd Congress, 2d Session (1974), as reported in 2 *U.S. Code Cong. & Admin. News*, 93rd Congress, 2d Session, 3266, 3268 (1974).

630. Rev. Rul. 74-146, 1974-1 C.B. 129.

631. Rev. Rul. 74-614, 1974-2 C.B. 164.

632. In Rev. Rul. 74-146, op. cit., note 630, the organization's membership included a small number of schools operated for profit.

633. 384 F. Supp. 776 (S.D. Ind. 1974).

Appendix

THE FEDERAL INCOME TAX EXEMPTION OF CHARITABLE ORGANIZATIONS: ITS HISTORY AND UNDERLYING POLICY

Chauncey Belknap[†]

The purpose of this memorandum is to trace the history of the provisions of the Federal Revenue Act granting exemption from income tax to eleemosynary organizations and to make an examination of the underlying policy which has led to the adoption of these provisions.

Development of the Federal Exemption

An exemption of charitable, religious, and educational organizations formed part of the first federal act that imposed a tax on the income and profits of corporations generally. This was the Revenue Act of 1894.[1] Earlier federal income tax statutes[2] (in force briefly during and after the Civil War) applied only to certain specified classes of business corporations, for example, railroads, canal companies, banks. No exemption provisions were needed to relieve charitable corporations from such taxes. But when the Revenue Act of 1894 placed a levy upon "all corporations organized for profit," Congress reinforced the implied exemption of charitable bodies with an explicit proviso, as follows:

> That nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious or educational purposes, . . . nor to the stocks, shares, funds, or securities held by any fiduciary or trustee for charitable, religious, or educational purposes . . .

A similar exemption has appeared in every subsequent federal income tax law.

The income tax of 1894 was soon declared unconstitutional (*Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895)), but in 1909 Congress enacted an excise tax upon corporate incomes[3] into which it carried over the substance of the 1894 exemption provision. After amendment of the Constitution in 1913,[4] Congress reestablished the income tax in the Revenue Act of 1913,[5] which also carried over the exemption provision. A list of the exemption provisions of the various federal revenue acts from 1909 to the present date is set forth in the Appendix. All of the acts contain the substance of the original exemption in favor of charitable, religious, and educational institutions.

Other provisions favoring such institutions were added to the federal tax structure from time to time. For example, in 1898, under the pressure of the war with Spain, a tax was imposed upon legacies.[6] At first, no exemption was accorded to legacies in favor of charitable, religious, and educational institutions. But in 1901 such an exemption was enacted,[7] applicable not only to all future legacies, but also to all prior legacies on which the tax had not yet been paid, and in 1902 Congress passed further legislation[8] requiring the Secretary of the Treasury to refund all taxes previously paid on such bequests.

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This paper was prepared in 1954 for The Rockefeller Foundation by its counsel, Chauncey Belknap, in cooperation with Philip Mandel. It has not been previously published and is presented here because of its historical interest and relevance to the questions considered by the Filer Commission.

The legacy tax did not long survive the exigencies of the war with Spain, but the fiscal demands of World War I revived the government's need to claim a share of dead men's fortunes. The estate tax of 1916[9] worked on a different scheme from the 1898 Act. This was a true estate tax, imposed at progressive rates increasing with the size of the entire estate, rather than a separate levy against each legacy. Under a legacy tax any exemption accrues directly to the advantage of the charitable legatee. Under an estate tax, however, if charitable bequests are made deductible in determining the estate subject to tax, the direct benefit of the deduction accrues to the advantage of the residuary legatee, which might or might not be the charity intended to be favored by the law. Probably for this reason – because the benefit to the charities of an estate tax deduction for charitable contributions was not certain, direct, and clear – the 1916 estate tax contained no charitable deduction.

However, in 1917 the charitable contribution deduction, limited to 15 percent of income, was enacted[10] with regard to the individual income tax, on the theory that by favoring the donor the deduction would stimulate contributions and thus help the charities.[11] The relevance of this theory to the estate tax was immediately apparent, and Prof. Samuel McCune Lindsay of Columbia University appeared before the Ways and Means Committee at hearings[12] on the proposed Revenue Act of 1918 to ask on behalf of universities and charitable agencies that an estate tax deduction be enacted. Despite the wartime need for revenue, Congress acceded.[13] Other federal tax provisions favoring "charities" have been enacted since, and exist today: exemption from admissions taxes;[14] exemption from gift taxes;[15] and the corporate contribution deduction.[16]

All of these provisions help charitable organizations either directly, by relieving them from the burden of taxation, or indirectly, by stimulating potential contributors to generosity. Together, they reflect a legislative policy of aid and encouragement to charitable organizations which has been consistently followed since the first exemption provision appeared in the Revenue Act of 1894.

Before that date, the general pattern of federal taxation left charitable organizations free from levy. Except for a brief interval during the Civil War, the federal government obtained its revenue from import duties and excise taxes.[17] The Civil War income taxes were levied on special classes of business corporations and thus spared charitable organizations from any burden. But it is noteworthy that the Civil War license tax,[18] under which even doctors and lawyers paid for the privilege of exercising their occupations, made an exception in favor of schoolmasters and clergymen. Also, the Act of June 30, 1864,[19] imposing taxes on the gross receipts of proprietors of lotteries, provided that if the managers of any charitable or benevolent association proved that the proceeds of a lottery were for charitable or benevolent uses, then the lottery was exempt from income taxes and license charges.

While the Revenue Act of 1894 contained the first specific statutory provisions granting exemption from federal income taxes, the policy of utilizing the tax structure to nurture and protect charitable organizations had a long prior history. By 1894 similar exemptions were well established in the property tax laws of the various states, and such exemptions had their origin back in medieval days. We turn next to an examination of this historical background.

Historical Background of the Federal Exemption

The English Statute of Charitable Uses

The grouping of religion, charity, and education as favorites of the law does not begin with American laws regarding income taxation, but has an ancient historical and legal basis.

During the Middle Ages, the church was the sole significant educational institution, as well as the principal dispenser of charity. In Greece and Rome, charity had been a governmental function. In the Judeao-Christian morality, charity was a duty to God. After the collapse of the Roman Empire, the church steadily grew in wealth, and religious bodies cared for the poor, the infirm, and the fatherless. During this time also, religious bodies preserved and perpetuated the ancient learning. In England, the church ultimately came to be so wealthy and powerful as to threaten the authority of the crown. Therefore, the church was first subjected to taxation,[20] and ultimately the bulk of its properties was confiscated.[21] In order to discourage gifts to the church, or for its use, mortmain statutes and other technical barriers were erected against successful completion of charitable gifts. But after the ascendancy of secular government had been made secure, and the church had been established as an organ of the State, relaxation of these rules appeared desirable.[22] The famous statute of charitable uses (43 Elizabeth c. 4) was an example of such relaxation. Although not within the framework of the tax law, this was essentially an exemption statute. The judges interpreted the statute as operating to perfect charitable gifts even though they were formally defective. Thus the statute exempted charitable gifts from the many technical traps and pitfalls of common law conveyancing, which had earlier been used to thwart charitable gifts and which still continued to upset many noncharitable transfers and conveyances. This principle of giving effect to the intent of the charitable donor led to the invention of the *cy pres* doctrine, which has since been an important feature of English and American law.[23]

In applying the statute of Elizabeth, the courts interpreted the favored uses broadly as including religion, education, and miscellaneous public uses. Thus the law of eleemosynary institutions is often referred to as the law of Charitable Institutions, and even today in the United States the concept of "charitable gifts" in various state laws (such as laws regarding perpetuities) includes gifts to religious and educational institutions.

Because of this historical and technical justification, and because it is convenient to have a group designation for all three types of institutions, the term "charitable" is sometimes used in this paper to comprehend charitable, religious, and educational.

Colonial and State Practice

Exemption of religious and educational institutions. The American colonist brought with him many of the traditions and customs of Europe, which included a tradition of tax exemption of church property, far antedating the English Reformation:

> A perusal of the history of tax exemption indicates that the granting of tax immunity to ecclesiastical and military property is probably as old as the history of taxation. Church property, for example, was exempted under the doctrine that it ceased to be under human control when it was devoted to God....Under the Saladin tithe, for instance, which is said to be the first occasion when movable property was regularly taxed, the books and apparatus of clergymen were exempted.[24]

In accordance with the English pattern, a number of the American colonial governments maintained established churches, and these were exempt from taxation. Most commentators explain the tax exemption of churches in the colonies as a result of this connection with the state—naturally, as a state organ, supported by taxation, the church would not be taxed.[25] However, since history shows that the church was exempt from taxation before it became an organ of the State, and has continued to be exempt in the United States long after governmental religious establishments have been prohibited by the Constitution, it is evident that the tax exemption of the church did not rest solely on its connection with the State.

Furthermore, tax exemption was not confined to the established church, nor was tax support. As the ideal of religious freedom spread in colonial America, dissenting churches came to be tolerated and ultimately to be supported out of tax funds. In 1727 Connecticut enacted an "Act for the Ease of such as soberly Dissent," providing that church taxes would be distributed *pro rata* to the dissenting as well as to the established churches. Other states had similar provisions, making the dissenting churches not only exempt from the payment of taxes, but beneficiaries of tax payments.[26]

The libertarian spirit of the American revolution substituted the ideal of religious liberty for that of an established church. Church and state were completely separated. The Constitituion prohibited Congress from establishing any church and from interfering with religious freedom, and various state constitutions had similar provisions. All of the American states, however, continued the practice of granting tax exemptions in favor of religion. Such exemption was "so entirely in accord with public sentiment that it universally prevailed."[27]

The Pennsylvania Constitution of 1776, adopted at the outset of the Revolution, provided: "... all religious societies or bodies of men, heretofore united, or incorporated for the advancement of religion or learning, or for other pious and charitable purposes, shall be encouraged and protected in the enjoyment of the privileges, immunities, and estates, which they were accustomed to enjoy, or could by right have enjoyed under the laws or former constitution of this state."

In some states, though no exempting legislation was passed, the exemption of churches was continued by custom and common understanding. In New Hampshire, for example, the first statutory exemption was enacted in 1842, but this merely formalized the existing practice.[28] In 1879 a New Hampshire statute was passed, limiting exempted church property to the value of $10,000. The attorney for a church that tried unsuccessfully to contest this limitation wrote in his points, without contradiction from his adversary: "Until the passage of this law no state or government has taxed church property."[29]

In New Jersey the exemption of churches existed without statutory authority until the enactment of an exemption statute in 1851. In 1853 a New Jersey court said that this custom "... was in fact a contemporaneous construction of the laws this Court would probably have sanctioned had the question been formally raised."[30]

In the earliest colonial days religion was a dominant motive of education, for it was necessary to train ministers who could study the holy writings and expound the Gospel.[31] The colonists were also concerned to keep learning from being buried in the graves of those who had been educated in the Old World. It is therefore natural to find tax exemption for education going hand-in-hand with the same privilege for religion in the early colonial legislation.

For example, the Massachusetts Bay Province Laws of 1706-7, granted the following exemptions from poll tax, property tax, and faculty tax:

> ... (except the governour and lieutenant-governour and their familys, the president, fellows and students of Harvard Colledge, setled ministers, grammar-school masters, and such who through age, infirmity or extream poverty, in the judgement of the assessors are rendred uncapable to contribute towards publick charges), who are hereby exempted, as well from being taxed for their polls, as for their estates being in their own hands, and under their actual management and improvement; and all estate, both real and personal, lying within the limits and bounds of such town or district, or next unto the same, not paying elsewhere, in whose hand, tenure, occupation or possession soever the same is or shall be found; ...[32]

The Revolutionary legislature preserved the colonial exemptions and the Massachusetts statute enacted in 1777-78 was not very different from that of 1706-7:

> *Provided, nevertheless,*—
>
> SECT. 4. That the following persons; viz., the president, fellows, professors, tutors, librarian and students of Harvard Colle(u)ge, who have their ususal residence there, and settled ministers of the gospel, and gramm(a)(e)r-school masters, are not to be assessed for their polls or their estates, unless their real estate be not under their actual management and improvement, or not in the parishes where they are settled; and also all persons who have the management and improvement of the estate belonging to Harvard Colle(d)ge, are not to be assessed for the same; and other persons, if such there be, who, through age, infirmity or extre(e)me poverty, in the judgment of the assessors, are not able to pay towards the public charges, they may exempt their polls or estates, or abate part of what they are set at, as they on their oath shall think just and equitable.[33]

As has been seen, in the section of the Pennsylvania Constitution of 1776 quoted above, organizations for the advancement of "learning" as well as religion were guaranteed continued protection of their accustomed privileges and immunities.

However, by the time of the American Revolution it was generally true that interest in education had taken a secular turn. Nearly every state constitution provided for the encouragement of education and science. The intense interest of Franklin and Jefferson in education is well known. In his first message to Congress, George Washington said: "... Nor am I less persuaded that you will agree with me in opinion that there is nothing more deserving your patronage than the promotion of science and literature. Knowledge in every country is the surest basis of public happiness. In one in which the measures of government receive their impressions so immediately from the sense of the community as ours it is proportionately essential."

Both in the colonies and the states the grant of tax exemption was an important method of fostering the growth of educational institutions. In most instances the colleges had to be started with the grant of governmental funds and supported for a time by annual contributions from taxation. But private funds were also solicited, and ultimately private support and control prevailed.

In 1890, four years prior to enactment of the first federal income tax exemption, the facts in regard to the practice of granting exemption to educational institutions were summarized as follows:

> ... This custom was almost universal among the colonies, and even extended so far as to exempt in several instances the property of the members of the college or university. Thus, Rhode Island formerly exempted all the property of the professors of Brown University from taxation, but when the charter was revised this feature was amended, so that now the property of each professor is exemped to the extent of ten thousand dollars only. The principle of exemption of educational institutions from taxation has been so grounded in the nature of our Government as to represent a practically irrevocable law.
>
> Historically, no more settled and constant policy has ever been adopted by so many States in regard to higher education. In the majority of the States either constitutional provision or statute law exempts property in actual use for educational purposes, while several go further and exempt the productive funds also.[34]

Exemption of benevolent organizations. Exemption of benevolent organizations for the relief of the poor and the sick did not come into being quite so early as religious and educational exemptions. For example, the early exemption statutes quoted above contain an exemption for individuals who through age, infirmity, or extreme poverty are unable to contribute towards public charges, but not for any organization ministering to such individuals. The reason is that institutional relief for the poor did not assume importance in this country until the nineteenth century.[35] In early colonial days the churches and towns had responsibility for the poor, and as time went on, the states gave increasing aid. Private persons performed the bulk of charitable work, but largely on an individual basis.[36] In the nineteenth century both public and private charitable work began to take institutional form, and tax exemption promptly followed:

> But the municipalities found themselves unable to cope with the task, and private philanthropy stepped in to do the necessary work. Then the spread of the *laissez faire* doctrine and its permeation of American thought lent the color of philosophic sanction to a process that was inevitably setting in because of the imperfection of the governmental machinery in administering so delicate a task as relief. Private relief was deemed more efficacious than governmental. For example, the Connecticut Commission of Inquiry recommended in 1856 the establishment of a privately controlled home for idiots, rather than one controlled by the government. Nor were the State authorities averse to the growth of private institutions, for on every occasion they added incentive to private bounty by offering a modicum of State aid on condition of large private endowments.
>
> But insofar as the State permitted private institutions to take over the work of charity, the latter were *pro tanto* relieving the State of a burden which it had avowedly undertaken to bear. Private institutions were thus performing a public function. The *quid pro quo* which the private institutions received was immunity from taxation. But it must be observed that what is done here is to state the terms of a bargain which we have not before us. It is not to be supposed that the bargain was openly made and publicly declared. There is no direct evidence that such a bargain was ever made. The process of exempting these private institutions developed imperceptibly, subtly. It was a spontaneous process, leaving no trace of its origin or immediate development.[37]

By 1894 the practice of granting tax exemptions in favor of religious, educational, and charitable institutions was virtually universal among the American states. Sometimes such exemption was granted by the state constitution, sometimes by general statute, sometimes by special act.[38] Sometimes, also, the tax exemption was granted in the charter of the institution – and such charter exemptions were held by the Supreme Court of the United States to be contractual in nature and thus within the constitutional prohibition against the impairment of contracts by states.[39] The consideration for the exemption was held to be present in the purpose of the organization, and sometimes in the private donations given in reliance on the charter: "The appreciation of the fact that education and refinement are more likely to go hand and hand with virtue, than are illiteracy and ignorance, that they best lead to good citizenship and the good order of the community, constitutes the consideration."[40] *Whitman College* v. *Berryman*, 156 F. 112, 119 (1907).

By and large the state exemptions prior to 1894 were property tax exemptions, principally real property exemptions. Most states exempted only realty actually used for the "charitable" purpose, although some states also exempted income-producing realty. Income-producing personalty was more likely to be exempted than productive realty – possibly because there is no other use for stocks and bonds, possibly because such personalty does not require service of the municipality.

But the exemptions granted by states were not limited to property tax exemptions. The Massachusetts statutes, cited above, involved "faculty"[41] taxes as well as property taxes. The faculty tax was a precursor of the modern income tax, and was designed to secure contribution to government from those who earned as well as those who owned. It seems to have been first enacted in Massachusetts Bay in 1646, and spread to some other New England States, but it never attained any real significance. As exemplified by the Massachusetts statutes quoted above, the exemptions under the faculty tax were the same as under property taxes.

Another form of tax used by the states in the nineteenth century was the legacy tax. As of 1917, immediately prior to the federal adoption of an estate tax deduction for "charitable" bequests, states had legacy taxes, and 34 of these had a "charitable" exemption.[42]

English Income Tax Exemptions

The English income tax practice may also be assumed to have influenced congressional thought in 1894 with regard to exemptions under the new income tax law.[43] By that date England had employed the income tax for nearly a hundred years, and almost from the first had granted a "charitable" exemption.[44] In the English statutes, the tax exemption applied to organizations having "charitable purposes." This phrase was broadly interpreted by the courts in accordance with precedents under the Statute of Charitable Uses (supra, p. 2026), and hence the exemption extended to religious, educational, charitable, and other miscellaneous public purposes.[45]

Summary of Historical Data

To recapitulate the historical data: The federal income tax favors to religion, charity, and education began in 1894 with the income tax exemption enacted that year. This was the first federal tax from which a significant exemption in favor of such organizations could be made, because prior to 1894 federal revenues were secured primarily from customs duties and excise taxes. For several years during and after the Civil War, the federal government employed income taxes, but none of these were levied in general terms against corporations or associations, and thus they did not evoke the exemption.

In 1894, the established practice in tax laws was such that the adoption by the federal government of the income tax exemption was inevitable. Prior to that time the important taxes in the country were the state property taxes, and from pre-Revolutionary days, exemptions in favor of religion, charity, and education were an integral part of such taxes, the exemptions being in some cases protected by state constitutions. Furthermore, the English income tax, nearly a century old by 1894, almost from the first had granted similar exemptions.

Underlying Policy of the Federal Exemption

As would be expected in the atmosphere that has been described, the 1894 exemption provision was enacted without debate and virtually without comment. Whether an income tax was desirable at all was the issue upon which all attention was focused. Congressman Tucker, in offering the amendment providing for the exemption, stated merely that it was intended to assure that "educational and charitable institutions may not suffer under the bill."[46] The exemption provision was accepted as a matter of course. The Congressional Record will be searched in vain for any fuller expression of the policy underlying the exemption.

Nor are we any better off when we go back to the exemption provisions in the colonial, state, and English tax laws, for they also appear to have been adopted without division of opinion. In this country, the development of the exemptions was probably rooted in the political philosophy which was widely prevalent in the early days, the thinking that led to the American Revolution and inspired the growth of the federal system. This was the spirit of classical liberalism, born in the writings of Montesquieu, Locke, and Bentham, and flowering in the political thinking of Franklin, Jefferson, Madison, and their followers.

The dominant tenets of classical liberalism were distrust of government and faith that the progress and well-being of mankind could best be achieved by natural forces harmonizing the individual actions of men who were left untrammeled. Individual and group enterprise were to be left free, for private initiative would in the end result to common advantage through the operation of automatic regulators such as the forces of competition and supply and demand. Such freedom of action and thought might lead to individual error, but a process of natural selection would winnow out the good from the bad and lead to the survival of what would be for the greatest good of the greatest number.

Among the founding fathers, the concepts of free and open competition of ideas and of official non-interference extended into the field of religion as well as other areas. Among Jefferson's letters is the following:

> In our university you know there is no Professor of Divinity. A handle has been made of this, to disseminate an idea that this is an institution, not merely of no religion, but against all religion . . . In our annual report to the legislature, after stating the constitutional reasons against a public establishment of any religious instruction, we suggest the expediency of encouraging the different religious sects to establish, each for itself, a professorship of their own tenets, on the confines of the university, so near as that their students may attend the lectures there, and have the free use of our library . . . ; preserving, however, their independence of us and of each other. This fills the chasm objected to in ours, as a defect in an institution professing to give instruction in *all* useful sciences . . . And by bringing the sects together, and mixing them with the mass of other students, we shall soften their asperities, liberalize and neutralize their prejudices, and make the general religion a religion of peace, reason, and morality.[47]

Many of these basic tenets of political thinking appear in Chief Justice Marshall's opinion in *Dartmouth College* v. *Woodward*, 17 U.S. 518 (1819): the limitation of governmental functions; the importance of education to the state; the necessity to preserve private educational efforts from state interference; the necessity to protect contractual arrangements from impairment by state action. Of the Dartmouth charter, Marshall said: "The objects for which a corporation is created are universally such as the government wishes to promote. They are deemed beneficial to the country; and this benefit constitutes the consideration of the grant."[48]

Furthermore, Marshall stated, if private individuals were to be expected to contribute voluntarily to eleemosynary institutions, they must be assured that the contracts surrounding their donations will be fulfilled. In protecting contracts against impairment, the framers of the Constitution had the purpose ". . . of withdrawing them from the influence of the legislative bodies, whose fluctuating policy, and repeated interferences, produced the most perplexing and injurious embarrassments . . ."

The State argued that it had the right to amend the charter granted by the King because Dartmouth, being an educational institution, was of special interest to the State. Marshall agreed that the State was concerned with education, but he pointed out that New Hampshire was not the intended beneficiary of the college, though the State would benefit through the college's contribution to the general welfare.[49] Further, Marshall argued, institutions of this character, although not performing a governmental function, make important contributions to the general welfare: "These eleemosynary institutions do not fill the place which would otherwise be occupied by government, but that which would otherwise remain vacant. They are complete acquisitions to literature. They are donations to education; donations, which any government must be disposed rather to encourage than to discountenance."[50]

These words of the great Chief Justice were uttered, it is true, in a context unrelated to taxes and tax exemptions, but like many of Marshall's opinions they illuminate a wider area than the immediate subject matter. They give expression, it is believed, to the implicit reasoning and the tacit convictions on which in this country the policy of tax exemption for eleemosynary institutions was based.

It is not mere coincidence that the *Dartmouth College Case* was later used by the Supreme Court as authority for its ruling that states could not impair tax exemptions they had earlier granted in college charters.[51] The principles and policy of the *Dartmouth College Case* apply to the tax-exemption cases as though tailor made. That policy recognized that these were institutions, to use Marshall's words, "which any government must be disposed rather to encourage than to discountenance." Why? Because of their contribution to the general welfare.

Note, particularly, Marshall's statement that "These eleemosynary institutions do not fill the place which would otherwise be occupied by government, but that which would otherwise remain vacant."

These words can hardly be too strongly underscored. Marshall was referring to privately supported educational institutions of higher learning. It is true that many eleemosynary institutions do fill a place that would otherwise be occupied by government, and especially by the welfare state of today. This has increasingly led legislators, courts, and text writers to put forward as the principal, if not the only, justification for tax exemption the saving of expenses to the government resulting from the operations of the exemption beneficiary. The argument supporting exemptions on this ground has obvious practical appeal.[52] But in spite of the heavy reliance that in many quarters is now placed on this reasoning for the support of tax exemptions, it is easy to demonstrate that not mercenary advantage to the government but a higher regard for public benefit has been the controlling motive of the lawmakers.

On this point, the exemption of religious institutions is convincing. Church and State have been separated since the Revolutionary period. Moreover, religion has never been a function of the federal government. In relieving the churches from taxation, government is not granting a favor to institutions whose place "would otherwise be occupied by government," but encouraging institutions to fill a place "which would otherwise remain vacant."

Going a step further, consider the exemption granted to missionary organizations, whose activities consist of preaching the gospel and doing good works in foreign lands. This is not only an activity barred to government; it may also be argued that the benefits accrue only remotely and indirectly to our own citizens. Yet no exemption is more securely established.

Turn next to the field of education, and take Harvard University as a test case. The income Harvard derives from its endowment funds, representing benefactions accumulated over three centuries, is exempt from federal income tax. But it cannot be contended in this case that (as the Ways and Means Committee Report on the Revenue Bill of 1938 argued[52]) "the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds . . ." The establishment and maintenance of institutions of higher education is certainly not the responsibility of the federal government.

It is equally true that the exemption from the local property tax which Harvard enjoys under the laws of Massachusetts cannot be explained on any theory that the state, or the municipality of Cambridge, which suffer the reduction of tax revenues, receive a quid pro quo from the University in the nature of a service that the state or local government would otherwise be obliged to render. If Harvard University did not exist, the State of Massachusetts would have no obligation to provide facilities for educating on the university level the thousands of non-residents of Massachusetts who now attend Harvard, and the City of Cambridge clearly is not giving the exemption as a quid pro quo for being relieved from a burden that it would otherwise have to assume.

As the foregoing test cases show, the quid pro quo explanation of tax exemptions, although it has achieved a wide currency and has gained in validity with the broadening of governmental functions, is not adequate as a justification of the privilege in some of the most important segments of the general area under discussion. It is evident that the tax exemption privilege has much deeper roots than the quid pro quo theory would admit.

The true explanation, and the only principle that affords a complete justification covering the entire field of exemptions in this general category, is that government relieves from the tax burden religious, educational, and charitable activities because it wishes to encourage them as representing the highest and noblest achievements of mankind. There is ample authority to support this position:

> They take a superficial view of the purpose and security of all government who disparage or disregard the aids afforded by education, charity and religion. The great end of all government for which all taxes are levied is to preserve order, secure life, liberty, reputation and property, and advance the civilization, promote the happiness, and moral and religious elevation of mankind. All these are more effectually secured and promoted by schools of learning, charitable relief, and moral and religious instruction and worship, than by all the Prisons and Poorhouses that were ever established and supported by government taxation. These, therefore, are legitimate objects for the encouragement of the government, as subserving the great purposes of all government, at least in the negative manner of exemption from taxation. Price, *Taxation of Learning, Charity and Religion* (1851).

People ex rel Seminary of Our Lady of Angels v. *Barber*, 42 Hun 27, aff'd 106 N.Y. 669 (1887):

> The policy of the law has been, in this State from an early day, to encourage, foster and protect corporate institutions of religious and literary character, because the religious, moral and intellectual culture afforded by them were deemed, as they are in fact, beneficial to the public, necessary to the advancement of civilisation, and the promotion of the welfare of society. And, therefore, those institutions have been relieved from the burden of taxation by statutory exemption.

Matter of Huntington, 168 N.Y. 399 (1901):

> The organized charities and benevolent agencies which actually relieve human misery, and labor in unselfish devotion to improve the moral and physical conditions of mankind, are alike the fruits and aids of good government, and to exempt their property – usually the gifts of the benevolent – from the burdens of taxation is scarcely less the duty than the privilege of the enlightened legislator.

People ex rel Soc. Free Church v. *Feitner*, 63 App. Div. 181 (1901):

> . . . it seems to us that it must be held that the entire building comes within the letter and spirit of the statute entitling it to an exemption from taxation. The policy of the law in this State, at least, is always to encourage corporate institutions of religious and literary character, upon the theory that instruction afforded by either elevates the individual and, therefore, benefits the State.

Blackmar, *History of Federal and State Aid to Higher Education in the United States*, 27 (1890):

> Education is not a money-making business; it is either a benevolence or a public defence. There is not an institution of advanced learning that can pay its way by tuition. There has been a sacrifice by the people at large through the State, or by individuals, or by organizations and associations. Referring to two of the foremost political economists, Adam Smith and John Stuart Mill, we find that their doctrines oppose the practice of the taxation of institutions of learning. Adam Smith's fundamental law of taxation seems to bear directly upon the question, when it declares that 'The subjects of every State ought to contribute toward the support of the government as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the State.' Who ever heard of an institution of learning enjoying revenues as stock-owners in a railroad company enjoy dividends? Does any one ever hear of educational

> institutions of higher learning declaring dividends to individuals? Education is on an entirely different basis. When a college or a university gets money, it buys books, builds libraries, purchases apparatus, employs extra teachers, or erects a new building, that the youth of the country, the best wealth of the State, may be better fitted for the duties of citizenship and for life.

In *Helvering* v. *Bliss*, 293 U.S. 144 (1934), the Supreme Court of the United States said, "The exemption of income devoted to charity" was "begotten from motives of public policy" and was "not to be narrowly construed."

Historically, it seems clear that the underlying motivation of the tax exemptions was not restricted to fiscal advantages to the granting government, nor even restricted to the welfare of its own people. Ideals of humanitarianism and piety prevailed, and these were not bounded by national lines. While some of our missionaries went abroad only to spread the gospel, many went abroad to do good works as well. Traditionally, great Americans have been moved by a feeling for all mankind, and not merely for their compatriots. Perhaps in earlier days the ideal of the brotherhood of mankind did not seem to be surrounded by so many thorns as today. A hint of the broad idealism of earlier times is afforded by the New York State Exemption Statute of 1893, which may have been the last such state statute passed prior to the 1894 federal exemption provision. The New York statute listed first among exempted purposes the moral and mental improvement of mankind:

> Section 1. *Exemption of property of certain non-business corporations.* – The real property of a corporation or association organized exclusively for the moral and mental improvement of men and women or for religious, charitable, missionary, hospital, educational, patriotic, historical or cemetery purposes, and used exclusively for carrying out thereupon one or more of such purposes shall be exempt from taxation. But no such corporation or association shall be entitled to any such exemption, if any officer, member or employee thereof shall receive or may be lawfully entitled to receive any pecuniary profit from the operations thereof except reasonable compensation for services . . .[53]

Who would then have changed this statute to read "the moral and mental improvement of men and women in New York State"? Who would then have advocated the deletion of missionary work from the exemption clause on the ground that this was not the concern of the enacting sovereign?

As indicated by the foregoing, government has granted the charitable tax exemptions in order to encourage voluntary private organizations to carry out certain activities which by common understanding are agreed to rate among the highest in the scale of social values. The preference that these activities be carried out by voluntary private organizations is based upon two advantages that private action in these fields enjoys over government action.

The first advantage is that voluntary private enterprise can often do the job better. Perhaps the most familiar example of this lies in the field of poor relief, where in some cases the work is turned over to private agencies even when the bill is borne by the government.[54]

New York State has long had a system of state payments to denominational charitable agencies. In the New York Constitutional Convention of 1894 this practice was considered by the Committee on Charities and Charitable Institutions. The committee reported in part as follows:

> The Committee is of the opinion that the public has received adequate return for all moneys paid to charitable institutions; that the expenditures made have been, in most instances, far less than if the institutions had been conducted by the public;. . . that the care of those in private institutions is better, in most instances, than that received in those under control of public local

> officers, and is, at least, as good and fully on a par with the institutions, fewer in number, directly under the control of the State itself;. . .[55]

The committee report further stated that the volunteers working with private agencies "bring to these institutions, not the perfunctory service which would be rendered by paid public officials, many of them qualified only by political service, but sincere devotion of officers, directors, managers and subordinates engaged in their work as a labor of love and not for emolument."

Similarly, no extended exposition is necessary to show the prevalence in American philosophy of the ideal of "freedom of education." And it is not necessary to argue at length that this ideal is not based upon any desire to shift the cost of higher education away from the government.

We believe that another important area in which the advantage of fostering private philanthropy has been demonstrated is the field of eleemosynary foundations, especially foundations organized for broad charitable purposes, such as "to promote the well-being of mankind throughout the world." As has been seen, such organizations have always enjoyed exemption from federal income tax. Foundations have been specifically mentioned in the exemption provisions of every federal income tax law beginning with the Revenue Act of 1921. The flow of funds into philanthropic foundations has been a remarkable voluntary recognition of the social responsibilities of great wealth. This is not the place to recite the many benefits these organizations have conferred upon mankind, but a statement of what their millions have accomplished as compared with the results of billions of dollars of governmental expenditure would be striking testimony in support of the superior efficiency of private enterprise in charity.

The second advantage of private control of these activities lies in the effect of such control upon the overall pattern of our society. This consideration in favor of private control and decentralization transcends the belief that private enterprise can do the specific job better. Regardless of marginal differences in efficiency between private enterprise and government enterprise, the broad ramifications of freedom require a preference for private activity and diversity. President Eliot of Harvard phrased it thus:

> The two nations in which endowments for public uses have long existed are the two free nations of the world. In England and the United States, the method of doing public work by means of endowments managed by private corporations, has been domesticated for several centuries; and those are the only two nations which have succeeded on a great scale in combining liberty with stability in free institutions. The citizens of a free State must be accustomed to associated action in a great variety of forms; they must have many local centres of common action, and many agencies and administrations for public objects, besides the central agency of government. France perfectly illustrates the deplorable consequences of concentrating all powers in the hands of government. Her people have no experience in associated action, and no means of getting any. To abandon the method of fostering endowments, in favor of the method of direct government action, is to forego one of the great securities of public liberty.[56]

A substantially similar modern view:

> These possibilities indicate that a wide range of choices is open to donors within which they may create charitable trusts under a diversity of terms and conditions. This freedom of choice, as well as the concept of the charitable trust itself, accords with the historic idea of a wide sphere of individual liberties, and is consonant with the pluralistic theory of society as distinguished from the doctrine of the monolithic state.

> Eschewing the idea of unlimited supremacy of the state, the pluralistic theory conceives the state as guardian of the liberty of the individual to cherish other allegiances not destructive of the state, and keeps the way open for the creation and growth of a great variety of voluntary institutions, agencies, and associations for purposes related to the welfare of mankind.[57]

Another modern statement of the same point of view was recently made by Theodore Geiger, research director of the National Planning Association, in Chapter I of "The Manual of Corporate Giving," a symposium written by experts in various fields of "charitable" activity:

> Private vs. Governmental Decision-Making
>
> The argument for maintaining a large measure of private support for educational, scientific, and welfare activities by no means rests solely on the desirability of keeping in check the demands upon the public purse and hence upon the taxpayer. More important, it is based upon the necessity of preserving to the maximum possible extent the decentralized and private character of the decision-making process in all phases of our national life.
>
> Not only our freedom but our continued progress toward a better life depend in part upon maintaining the rich diversity of values and abilities and the powerful motive force of individual initiative and insight which have hitherto characterized our culture. To the extent to which, in any important sector of our national life, the centralization of decision-making passes beyond a certain point, these prerequisites of freedom and progress are sacrificed.
>
> Some centralization of decision-making – whether in governmental or in private hands – is, of course, always necessary; and no doubt more may be inevitable in the kind of world in which we live today. But there is less need or justification for it in the fields appropriate for five percent activities than in many others. Education and science are two activities in which progress is particularly dependent upon intellectual freedom, multiplicity of viewpoints and interest, and diversity of individual inspiration and action. A necessary element in the field of social welfare is the kind of pioneering and the direct human approach which government agencies cannot normally attain. The quality of our activities in education, science, and welfare cannot long be maintained unless there is a firm foundation of private initiative and control.
>
> Such a view does not by any means imply a belief that all individual acts are good or socially useful. Though there undoubtedly will be some duplication and inefficiency, these are a necessary price to pay for the preservation of individual initiative and decision-making dispersed throughout the land. For, freedom and multiplicity of actions do provide the best – and perhaps the only – guarantee that some vital lead in science will not be missed, some promising education method disregarded, some fruitful insight into human behavior suppressed, or some challenging inspiration in art, literature, or music allowed to wither for lack of support. In the last analysis, the major reason why public policy should favor the effective use of the five percent privilege by corporations is because it will help to preserve the necessary decentralization and diversity of decision-making in the educational, scientific, and welfare fields.[58]

In the same volume, in a chapter on higher education, John W. Millett wrote:

> Thanks to the variety (of institutions), we have healthy competition among colleges and universities, and we have insured an opportunity for the

> expression of many different educational points of view, from the most progressive to the most conservative. The number and diversity of our schools have made it impossible for any one group in our society, either through private or governmental channels, to gain domination of higher education, and have promoted the best interests of academic freedom. The flexibility of our universities in opening up new lines of study helps to explain why such a large portion of our youth goes on from high school to higher education. In short, the diversity of the field of higher education is a true reflection and, at the same time, one of the bulwarks of our free society.

In another chapter of the same volume, Clarence E. Pickett points to the disadvantages of governmental foreign aid programs in terms that invite comparison with the activities of tax-exempt foundations in the same field:

> Foreign aid programs administered by governmental and inter-governmental agencies and supported by tax funds cannot be expected, in many cases, to promote qualities of personal friendship and interest. In some cases, the political tag attached to government efforts limits or even nullifies their permanent effectiveness, although as temporary measures they help stem the tide of distress. In other cases, the enormous size and emergency, short-term nature of the governmental type of project give little scope for the expression of a deep human concern.[**]

We have seen, therefore, that the policy underlying the tax exemption of charitable organizations is motivated primarily by a desire on the part of government to encourage activities contributing to the general welfare and by a belief that voluntary private organizations have certain definite advantages over government agencies in conducting these activities. It remains only to emphasize the peculiar suitability of tax exemption as an instrument by which government can give such encouragement without impairing the independence of organizations receiving the benefit. Being of general application, and therefore operating automatically in favor of all organizations that meet the standards set by the Revenue Act, the tax exemption provisions insulate private charitable enterprises from the government domination which is invited by the alternative method of direct grants by government. This was brilliantly stated by President Eliot in 1874, long before the malignant growth of totalitarian states made the dangers inherent in government control plainly apparent:

> It has been often asserted, that to exempt an institution from taxation is the same thing as to grant it money directly from the public treasury. This statement is sophistical and fallacious. It is true that the immediate effect on the public treasury is in dollars and cents the same, whether Harvard University be taxed $50,000, and then get a grant of $50,000, or be exempted from taxes to the amount of $50,000 and get no grant. The immediate effect on the budget of the university would also be the same. The proximate effects of these two methods of state action in favor of religion, education and charity are however unlike, — so unlike, indeed, that one is a safe method, while the other is an unsafe method in the long run, though it may be justifiable under exceptional circumstances. The exemption method is comprehensive, simple and automatic; the grant method, as it has been exhibited in this country, requires special legislation of a peculiarly dangerous sort, a legislation which inflames religious quarrels, gives occasion for acrimonious debates, and tempts to jobbery. The exemption method leaves the trustees of the institutions fostered untrammelled in their action, and untempted to unworthy arts or mean compliances.
>
> The grant method, as practised here, puts them in the position of importunate suitors for the public bounty, or, worse, converts them into ingenious and

unscrupulous assailants of the public treasury. Finally and chiefly, – and to this point I ask special attention, – the exemption method fostors public spirit, while the grant method, persevered in, annihilates it. . . .

The exemption method is emphatically an encouragement to public benefactions. On the contrary, the grant method extinguishes public spirit. No private person thinks of contributing to the support of an institution which has once got firmly saddled on the public treasury. The exemption method fosters the public virtues of self-respect and reliance; the grant method leads straight to an abject dependence upon that superior power – Government. The proximate effects of the two methods of state action are as different as well-being from pauperism, as republicanism from communism. It depends upon the form which the action of the State takes, and upon the means which must be used to secure its favor, whether the action of the State be on the whole wholesome or pernicious. The exemption is wholesome while the direct grant is, in the long run, pernicious.[61]

Conclusion

Since medieval times, certain activities rating high in the scale of contemporary values have been accorded tax exemption. From the time when old world culture was first transplanted to America, charitable activities have been granted various forms of tax favors. The basic motive for these tax favors has been a wish to encourage activities that were recognized as inherently meritorious and conducive to the general welfare. In some cases it was also true that the exempted organizations performed activities that government would otherwise be forced to undertake, but it is believed that governmental saving has not been the decisive factor influencing the exemption of charitable activities from tax.

Some of these activities, as a matter of law or tradition, fall outside the scope of government action. Others, although within the area where government action would be permissible, are regarded as better left in private hands, for two reasons. The first reason is that private enterprise and diversity of action are believed to do the specific job better. The second reason is that the preservation of the American policies of individual initiative and of decentralization is deemed vital in itself.

The co-ordinate privileges of tax exemption and deductibility for tax purposes of gifts to tax-exempt organizations are remarkably well-conceived devices by which government can aid and stimulate private charitable enterprise, without subjecting it to control.

The essence of the advantage of this system is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and the choices of private givers. The donors determine the direction of their own funds, and the distribution of "tax savings" as well. The income of each individual organization is a product of donations it receives and the investment wisdom of its managers. Since all of these operations are out of the hands of government under the exemption and deduction statutes, the beneficiary organizations receive their governmental aid without having to petition for it. They are, therefore, in President Eliot's words ". . . untrammelled in their action, and untempted to unworthy arts or mean compliances."

Similarly, under the automatic system of tax exemptions and deductions, private bodies, and not government, determine the application of the funds. Private conviction and inspiration, in all of their diversity, are free to inquire, to experiment, and to take action. Effort may be wasted, mistakes may be made, agencies may even work at cross-purposes; but in the long run the well-being of mankind is thus fostered. The basic premise of the system is that progress comes through freedom.

Appendix

STATUTORY HISTORY OF PRESENT SECTION 101 (6) I.R.C.

(Only Acts making a change in substance or numbering of the provision are printed)

Act of August 5, 1909, C. 6, 36 Stat. 113, § 38 First [2]:

"Provided, however, that nothing in this section contained shall apply to . . . [d] nor to any corporation or association organized and operated exclusively for religious, charitable or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."

Act of October 3, 1913, C. 16, 38 Stat. 166, § II G(a) [2]:

"Provided, however, That nothing in this section shall apply to . . . [f] any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual, . . ."

Act of September 8, 1916, C. 463, 39 Stat. 756, § 11(a):

"(a) That there shall not be taxed under this title any income received by way — . . . Sixth. Corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual;"

Act of February 24, 1919, C. 18, 40 Stat. 1057, § 231:

"That the following organizations shall be exempt from taxation under this title — . . . (6) Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;"

Act of November 23, 1921, C. 136, 42 Stat. 227, § 231:

"That the following organizations shall be exempt from taxation under this title — . . . (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;"

Act of June 2, 1924, C. 234, 43 Stat. 253, § 231:

"The following organizations shall be exempt from taxation under this title — . . . (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual;"

Act of May 29, 1928, C. 852, 45 Stat. 791, § 103:

"The following organizations shall be exempt from taxation under this title —. . . (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual;"

Act of May 10, 1934, C. 277, 48 Stat. 680, § 101:

"The following organizations shall be exempt from taxation under this title — . . . (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;"

Act of September 23, 1950, C. 994, 64 Stat. 906, § 332(c):

This Act amended § 101(6) to read as follows:

"Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances, see sections 3813 and 3814."

Footnotes

1. Act of August 15, 1894, C. 349, 28 Stat. 553.

2. Civil War income tax laws were in effect from 1861 through 1872 under the following statutes: 12 Stat. 292, C. 45 (1851); 12 Stat. 432, C. 119 (1862); 12 Stat. 713, C. 74 (1863); 13 Stat. 223, C. 173 (1864); 13 Stat. 469, C. 78 (1865); 14 Stat. 4, C. 15 (1866); 14 Stat. 98, C. 184 (1866); 14 Stat. 471, C. 169 (1867); 16 Stat. 256, C. 255 (1870).

3. 36 Stat. 11, C. 6.

4. U.S. Const., Amendment XVI.

5. 58 Stat. 114, C. 16.

6. 30 Stat. 448, C. 448.

7. 31 Stat. 993, C. 806.

8. 32 Stat. 406, C. 1160.

9. 39 Stat. 756, C. 463.

10. 40 Stat. 300, C. 63, Title XII, § 1201 (2).

11. See Mertens, *Law of Federal Income Taxation*, Vol. 5, p. 516 (rev. ed. 1953).

12. See *Hearings before Committee on Ways and Means on Proposed Revenue Act of 1918*, House of Representatives, 65th Cong., 2d Sess. Vol. I, p. 887 *et seq.*

13. 40 Stat. 1057, C. 18, Title IV, § 403 (a) (3).

14. Int. Rev. Code, § 1701.

15. Int. Rev. Code, § 1004(a) (2) (B).

16. Int. Rev. Code, § 23(a) (2).

17. For a history of the Internal Revenue System in the nineteenth century, see Eldridge, *The United States Internal Revenue System*, 21-24 (1895).

18. 12 Stat. 432, C. 119 § 64.

19. 13 Stat. 223, C. 173, § 11.

20. Adler, *Historical Origin of Tax Exemption of Charitable Institutions*, (1922), p. 44.

21. *Ibid.*, p. 26.

22. *Ibid.*, pp. 62, 63.

23. See Bayle, *Law of Charities*, 18-23 (1837).

24. Stimpson, "The Exemption of Property from Taxation in the United States," 18 *Minn. L. Rev.* 411,416.

25. *Ibid.; cf. The Franklin Street Society v. Manchester*, 60 N.H. 342 (1880).

26. Zollman, *American Civil Church Law*, 239 (1917).

27. *State v. Jersey City*, 24 N.J. L. 108, 120 (1853).

28. *The Franklin Street Society v. Manchester*, 60 N.H. 342 (1880).

29. *Ibid.*

30. *State v. Jersey City*, 24 N.J. L. 108, 120 (1853).

31. Blackmar, *History of Federal and State Aid to Higher Education in the United States*, (1890), p. 23.

32. Province Laws 1706-07, C. 6, § 2.

33. Province Laws 1777-78, 3d Sess., § 4, p. 13.

34. Blackmar, op. cit., p. 25.

35. See Capen, *Historical Development of the Poor Law of Connecticut* (1905).

36. Edwards, *New York as an Eighteenth Century Municipality*, p. 100, Vol. 75, Pt. II, Columbia University Studies in Hist. Econ. & Publ. Law (1917).

37. Adler, op. cit., p. 73.

38. See Stimson, op. cit., p. 411, and Baker, *Tax Exemption Statutes*, 7 *Texas L. Rev.* 50.

39. *University v. People*, 99 U.S. 309 (1878).

40. *Whitman College v. Berryman*, 156 F. 112, 119 (1907).

41. With regard to the nature and prevalence of faculty taxes, see Seligman, *The Income Tax*, 368 et. seq. (1911); Foster and Abbott, *Income Tax Law of 1894*, 1, 2 (1895).

42. Pamphlet, *National and State Legislation on Exemption from Taxation of Bequests and Gifts to Education, Philanthropy and Religion.*

43. The English experience was cited frequently in the congressional debates over the 1894 income tax provisions.

44. Dowell, *Acts Relating to the Income Tax*, 76-87 (9th ed. 1926); Kenny, *The True Principles of Legislation with Regard to Property Given for Charitable or Other Public Uses*, 249 (1880).

45. *Commissioners v. Pemsel*, A.C. 531, 61 L. J. Q. B. 265 (1891).

46. 26 *Congressional Record*. 1727.

47. *The Writings of Thomas Jefferson*, Vol. X, p. 243.

48. *Dartmouth College v. Woodward*, 17 U.S. 518, 637 (1819).

49. *Ibid.*, 640.

50. *Ibid.*, 647.

51. See p. 2030, supra.

52. A typical statement of that point of view: "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. The United States derived no such benefit from gifts to foreign institutions, and the proposed limitation is consistent with the above theory. If the recipient, however, is a domestic organization the fact that some portion of its funds is used in other countries for charitable and other purposes (such as missionary and educational purposes) will not affect the deductibility of the gift." *Ways and Means Committee Report on Revenue Bill of 1938*, C.B. 1939 – 1, 742, House Rep. 1860, 75 Congress, 3rd Session.

53. Laws of 1893, C. 498.

54. See quotation from Adler, op. cit., p. 14.

55. New York Constitutional Convention, 1894, Document No. 59.

56. Eliot, *Views Respecting Present Exemption from Taxation of Property Used for Religious, Educational and Charitable Purposes*, p. 392.

57. Chambers, *Charters of Philanthropies*, 2 (New York, 1948).

58. Beardsley Ruml, ed., *The Manual of Corporate Giving*, National Planning Association (Tennessee, 1952).

59. *Ibid.*, pp. 207,208.

60. *Ibid.*, p. 369.

61. Eliot, op. cit., pp. 382-3.

TAX POLICY RELATING TO ENVIRONMENTAL ACTIVITIES AND PUBLIC INTEREST LITIGATION

A.M. Wiggins, Jr.,[†] and Bert W. Hunt[*]

Introduction

Our project originated with the request that we explore and analyze tax policy issues relating to environmental matters, including, in particular, an examination of environmental litigation. Our paper was to be a close examination of a subtopic falling within the general topic of "charity" on which another team of lawyers was preparing a legal research report. At the time, it seemed that we would be addressing ourselves to a reasonably narrow and well-defined subtopic. However, it soon became apparent (for the reasons explained at length in this report) that environmental litigation cannot be adequately dealt with as a separate subject but must be considered as a component of "public interest litigation."

Public interest litigation is a comparatively new field of private charitable activity. Its boundaries are nowhere defined and are perceptible with only the most careful and critical analysis. Within these boundaries lie many areas for policy judgments which have not yet been authoritatively determined and on which individuals may hold widely divergent views. In 1970 the Internal Revenue Service was the center of a storm of controversy concerning its rulings policy toward public interest litigation organizations. The storm abated upon the issuance by the IRS of its "guidelines" for "public interest law firms." The Commissioner of Internal Revenue later explained that the Service had attempted to generate the widest possible public input to assist it in formulating its policy, but at the time many (if not most) people sought to attribute other motives to the IRS. The Commissioner also stated that a rewriting of the Treasury Regulations would be undertaken so that the subject of public interest litigation would receive recognition and definition through the formal rule making process. This process involves the opportunity for public comment on proposed regulations and, in many cases, a public hearing.

To date, no new regulations on public interest litigation have been proposed. Moreover, a matter of vital concern to public interest law organizations – the receipt of attorneys' fees – has only recently been the subject of rulings by the IRS, the first of which were a few private rulings issued in October 1974 and the last of which were public rulings announced on February 19, 1975.

It is our hope that this report, which in the main is devoted to a discussion of public interest litigation, will not only provide material that will be useful to the Filer Commission in its deliberations but will also provide the Internal Revenue Service with material (not to mention stimulus) for its regulations project and, when published, provide interested members of the public with sufficient information to evoke thoughtful comment. It is our further hope that the new regulations, and the process of public debate thereon, will not be long in coming.

Scope of Report

This report examines the application of the federal tax law, principally section 501(c) (3) of the Internal Revenue Code,[1] to activities related to our environment. Specifically, it seeks to identify and analyze (1) the policies underlying the recognition of tax exemption for certain environmental activities and the denial of such benefits to other environmental activities, and (2) other issues of tax policy arising from environmental activities. Emphasis is directed to those activities of more recent concern and to those of a more controversial nature. Private philanthropy has had the most far-reaching environmental impact through litigating activities, and these activities, as a part of the broader topic of public interest litigation, receive the most attention herein.

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Section 501(c) (3) does not expressly refer to environmental activities or to public interest litigation. It does, however, grant tax exemption to "charitable," "educational," and "scientific" organizations, and most environmentally oriented organizations, as well as those engaging in other areas of public interest litigation, must come within one or more of these criteria to qualify for tax exemption under this section. The term "charitable" is construed by the Treasury Regulations to include, among other things, the promotion of social welfare by combating community deterioration, the defense of human and civil rights secured by law, and the lessening of the burdens of government.[2] "Education" is defined to include instruction of the public on subjects useful to the individual and beneficial to the community.[3] "Scientific" is defined principally in terms of research conducted to produce a public benefit.[4] Common to all is the underlying policy that a tax-exempt entity must be organized and operated exclusively to serve a public, as opposed to a private, purpose.[5]

I

DISTINCTION BETWEEN SECTION 501(c) (3) AND SECTION 501(c) (4)

The Nature of the Distinction

Section 501(c) (4) exempts from income tax "organizations not organized for profit but operated exclusively for the promotion of social welfare" (together with civic leagues and local associations of employees, neither of which is relevant to this report). The regulations explain that an organization may be exempt under section 501(c) (4) "if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community."[6]

Note that the promotion of social welfare by an organization engaged in providing relief for the poor, advancing religion, education, or science, lessening the burdens of government, combating community deterioration, or certain other activities expressly enumerated in the section 501(c) (3) regulations rises to the level of section 501(c) (3) "charity" and entitles the organization to exemption under that section (see introduction to this report). The difference between a charity and a social welfare organization is one of degree which cannot be delineated with precision. Those activities in which broad public benefit predominates, or which conform to traditional legal concepts of charity, usually qualify as section 501(c) (3) charity, while other activities of lesser significance, such as the operation of a community roller skating rink,[7] the conduct of youth sports activities,[8] or the providing of facilities and instruction for firearms,[9] promote the common good and welfare but are not as important in terms of broad public benefit and therefore fall short of the charitable classification. An extensive analysis of the criteria for identifying "charity" is beyond the scope of this paper; an indepth study of these criteria is the subject of a separate report prepared for the Commission (see John P. Persons, John J. Osborn, Jr., and Charles F. Feldman, "Criteria for Exemption Under Section 501(c) (3)").

Tax Consequences of the Distinction

Section 501(c) (3) and section 501(c) (4) organizations enjoy the same exemption from the payment of federal income tax, but two important differences exist. The first is that contributions to a section 501(c) (4) social welfare organization generally are not deductible as charitable contributions for federal income, gift, and estate tax purposes. The second difference is that social welfare organizations are not subject to the statutory prohibition against substantial lobbying activities that is applicable to all charitable organizations. Thus, an organization can be tax exempt under section 501(c) (4) even if its social welfare objectives can be attained only by the enactment or defeat of specific legislation. The IRS has publicly ruled that an organization formed to represent "the public interest" at legislative and administrative hearings on tax matters qualifies for exemption under section 501(c) (4).[10]

Impact on Environmental Activities

The distinction between charitable and social welfare organizations and the tax consequences of that distinction have had a significant impact on the environmental movement. One of the nation's oldest and largest environmental organizations, the Sierra Club, was for most of its existence recognized by the IRS as a section 501(c) (3) charitable organization. However, many of the environmentalists' objectives can be accomplished only by the enactment or defeat of legislation, particularly legislation in the United States Congress. In the mid-1960s the Sierra Club's legislative activities reached such a level that the IRS concluded they were "substantial" and therefore violative of the section 501(c) (3) prohibition against substantial lobbying. After a lengthy and well-publicized encounter, the IRS made a final decision to revoke the Sierra Club's section 501(c) (3) status. The Sierra Club subsequently applied for and was granted status as a section 501(c) (4) social welfare organization.

Section 501(c) (4) status permits much greater freedom for lobbying – greater freedom in terms of the extent to which an organization can engage in lobbying activities and in terms of direct legislative efforts on behalf of specific points of view. Such freedom is therefore attractive to many environmental organizations, but the nondeductibility of contributions must certainly affect a social welfare organization's ability to raise funds from the private sector. Several environmental organizations have consciously chosen section 501(c) (4) status at their inception to take advantage of the greater freedom. Some environmental organizations have created separate (but parallel) section 501(c) (3) and section 501(c) (4) organizations, the former to receive tax-deductible contributions and concentrate on non-lobbying environmental activities and the latter to receive nondeductible contributions or membership dues and concentrate on environmental lobbying activities.

An analysis of the lobbying constraints is another topic outside the scope of this paper and is also the subject of a separate report to the Commission (see John B. Huffaker, "Legislative Activities of Charitable Organizations Other than Private Foundations, with Addendum on Legislative Activities of Private Foundations"). It is mentioned here solely to describe its impact on environmental activities.

II

ACTIVITIES TRADITIONALLY RECOGNIZED AS CHARITABLE OR EDUCATIONAL

Federal Policy Toward Conservation of Natural Resources

The establishment of a federal policy of concern for conservation and the environment is by and large a development of the twentieth century. Legislation with a significant environmental aspect dating from the nineteenth century was of limited scope, and those who sought protection of interests that today would be classified as environmental in nature necessarily depended upon judicial doctrines, such as that of common law nuisance.[11]

The dominant theme of the last century could be fairly characterized as having been a desire to exploit the natural resources of the United States as a means of rapidly increasing the size and prosperity of the nation. Thus, for example, the Mining Act of 1866,[12] which served to legislatively sanction a policy earlier adopted through inaction, declared the lands owned by the federal government to be "free and open" to exploitation for minerals and for mining and granted ownership (via land patent) to any discoverer of significant mineral deposits on federal lands. This policy was continued without substantial alteration by the General Mining Laws of 1872[13] and, despite the passage of more than 100 years and frequent criticism,[14] remains the basic policy of the federal mining laws today. Flagrant abuses of the mining patent system caused Congress in 1910 to enact the Pickett Act,[15] authorizing the President to withdraw unappropriated public lands from the operation of the Mining Laws of 1872. During the period 1910 to 1920, most such unappropriated public lands were not subject to exploitation, but the Mineral Leasing Act of 1920[16] served to convert the mining laws, with regard to oil, coal, gas, and certain other minerals, into an exclusive lease (rather than land patent) system; hard minerals other than those exempted remain even today subject to the legislative policy of 1872.

In 1862 Congress passed the Homestead Act, which generally granted ownership of public lands to whomsoever desired to exploit them. Congressional treatment of public lands in the last century, however, was not solely in the direction of their transfer to private ownership. In 1891 Congress passed a law authorizing the President to set aside from the public domain certain lands to be designated as national forests,[17] and at at earlier date (1872) Congress had itself created Yellowstone National Park. The national forests, however, were not and are not today free of private exploitation (for minerals and timber), and this is true even if the land in question has been designated a Wilderness Area under the Wilderness Act of 1964[18] where the mineral patent holder's rights predate 1964.

The earliest federal water pollution control legislation dates back to 1886 when Congress enacted a statute making it unlawful to discharge certain enumerated articles into New York harbor. In the Rivers and Harbors Act of 1899,[19] Congress enacted a similar provision, making it unlawful to deposit "any refuse matter of any kind" into a navigable waterway. Although Section 13 of that statute was rediscovered in 1970 as an anti-pollution statute, it is probable that Congress in 1899 had the protection of navigation as its principal goal.[20] In the 1920s oil spills became a national problem and Congress enacted the Oil Pollution Control Act.[21] Until passage of the first Federal Water Pollution Control Act,[22] however, federal activity in the field of water pollution control was minimal; the 1948 act, moreover, stated as its policy that water pollution control was primarily a task for the states.[23]

The first federal air pollution legislation was not enacted until 1955. That act, however, merely provided for grants-in-aid to state and local pollution control agencies and authorized the federal government to render technical assistance. No attempt was made to exercise federal police power nor to establish federal standards for air purity.

Some of the federal agencies concerned with conservation and environmental problems are the Federal Bureau of Reclamation, Corps of Engineers, Bureau of Indian Affairs, Federal Power Commission, Atomic Energy Commission, Department of Interior (Fish and Wildlife Service, Bureau of Outdoor Recreation and National Park Service), Department of Agriculture (National Forest Service), the Coast Guard and, most recently, the President's Council on Environmental Quality and the Environmental Protection Agency.

Traditional Private Philanthropy

Many environmental activities have traditionally been recognized by the IRS as charitable or educational. Some of these are public zoos, wildlife sanctuaries, and various forms of conservation facilities. A review of some of the published IRS revenue rulings illustrates some of these activities. In 1954 the IRS held that contributions made to a committee established for the purpose of developing land as a public park were deductible.[24] In 1965 the Commissioner of Internal Revenue stated that contributions to programs designed to conserve the nation's beauty were deductible.[25] Gifts could be in the form of money, land or other property to governmental agencies or qualified organizations engaged in fostering natural beauty. Scenic easements (a topic discussed more fully later in this report) were also qualified for tax deductions.

Some of the traditional organizations recognized are organizations under state control organized for the purpose of securing and developing, for the education of the public, a tract of forest land to be reserved as a sanctuary for wild birds and animals. Others are organizations that maintain a free library of materials on gardening and similar subjects; give lectures and free advice on conservation of trees and plants; and make awards to children for gardening achievements. Additionally, there are organizations that maintain a clearinghouse for the exchange of information on gardening; encourage roadside beautification; educate the public by means of radio, TV, and lecture programs; and make awards for civic achievement in conservation and horticulture. Also included are organizations formed for conservation and protection of native wild flowers; encouragement of civic planting; preservation of scenic and historical localities; and encouragement of general participation in all activities that may result in the enhancement of aesthetic and scenic values of urban and suburban communities and rural landscapes. And, finally, there are those organizations that disseminate information on corrective gardening procedures; promote conservation practices through education, camps, and scholarships; and sponsor teachers' workshops at colleges in gardening and conservation practices.

In 1967 the IRS ruled that an organization formed for the purpose of developing a sanctuary for wild birds and animals for the education of the public was a section 501(c) (3) educational organization.[26] Likewise, the IRS ruled that an organization formed to develop and distribute a community land-use plan qualified for tax-exempt status.[27] However, in the same year, the IRS, in another published ruling, made clear that an organization substantially engaged in promoting legislation to protect or otherwise benefit animals is not a section 501(c) (3) organization even though the legislation it advocates may be beneficial to the community and its attempts to influence legislation may be indirect.[28]

Section 501(c) (3) recognition was given in 1968 to an organization operated to preserve and develop the beauty of a city[29] and also to an organization formed to help the National Park Service to improve and expand its educational and scientific programs.[30] In 1970 the IRS ruled that an organization formed to preserve and improve a lake used extensively as a public recreational facility qualifies for section 501(c) (3) tax exemption.[31] Similarly, the IRS ruled in 1972 that an organization formed to educate the public regarding environmental deterioration due to solid waste pollution and operated with contributions and proceeds from the sale of collected solid waste for recycling is tax exempt.[32]

The foregoing are just some of the rulings and public announcements. However, they are a cross section of the environmental activities traditionally recognized as tax exempt under section 501(c) (3), and our research and investigation have disclosed few areas of controversy or unresolved tax policy issues.

Several section 501(c) (3) organizations provide assistance on a continuing basis to governmental agencies. These organizations devote considerable time and effort to both federal and state agencies by rendering expert advice as to environmental concerns, such as complete land conservation packages; this includes assistance on techniques, identification, tax policy, legislation, bond issues, and computer systems for assembling and analyzing data, among other things. Some of the advice is given without compensation, while other times the organizations provide land use and other resource planning on a paid contract basis. These organizations are helping state agencies collect environmental information, keep it current and utilize the data. The tax problems these organizations have in fulfilling their purposes in assisting governmental agencies and dealing with others are discussed later in this report.

III

ACTIVITIES OF MORE RECENT CONCERN OR CONTROVERSIAL NATURE

This part of our report focuses on some of the newer activities in the environmental field, other than public interest litigation, and describes the tax policy issues encountered therein. The first two sections contain background information intended to provide the setting within which the tax policy issues relating to private philanthropy should be considered.

Federal Environmental Policy

The past half decade has witnessed an explosion of congressional interest in and protection of the environment. In the National Environmental Policy Act of 1969,[33] (NEPA), Congress declared it to be the "national policy . . . [to] encourage productive and enjoyable harmony between man and his environment." Section 102(C) of NEPA requires all recommendations or reports proposing major federal actions that may "significantly affect" the quality of the human environment to be accompanied by a detailed statement predicting the "environmental impact" of the proposed action. Litigation concerning the requirements of NEPA for such a statement and the sufficiency of the statement, if drafted, has proven voluminous, in large part because the statute does not define the term "environmental impact" – the definition therefore requires administrative and judicial action.

In 1970 Congress amended the existing Clean Air Act so drastically as to produce a virtually new statute.[34] The administrator of the act (now the administrator of the Environmental Protection Agency, EPA) is authorized for the first time to set *national* standards for ambient air quality, and there was established a detailed procedure requiring individual states to submit implementation plans demonstrating that the state has sufficient resources and stringent enough emission standards to enable the state to meet the ambient standard set by the administrator before the deadline of the act, generally mid-1975. Efficient means of enforcement were provided, and criminal penalties for knowing violation of the act were incorporated. Provision was also made for lawsuits by private citizens affected by action under the statute.

In 1972 Congress overrode a Presidential veto and enacted amendments to the Federal Water Pollution Control Act,[35] again extensively revamping the existing statute. Under the new legislation, the administrator of the EPA is authorized to define by regulation the best practicable technology to reduce pollution in existing industrial effluent discharges and to require installation of that technology before July 1, 1977. In the interval 1977-1981, communities and industries will be required to install the best available technology, regardless of practicability, with a goal of zero discharges set for attainment in 1983. An expanded permit system has been imposed, and criminal and civil penalties are provided for violators. Again private citizen suits are authorized.

Governmental control is not limited to our water and air; it has also extended to noise, pesticides and other toxic substances and generally is reaching into all aspects of human environment. The legislative tide has been running strongly in favor of environmental activism. The Presidential veto of the Federal Water Pollution Control Act Amendments of 1972 was based on the grounds that implementation of the statute would be too costly for the federal treasury (expenditures for municipal sewerage treatment), but Congress determined that the price must be paid.

Pollution Control and Abatement

Basic Policy Issues

The major policy issue with respect to pollution control is to determine who shall pay the costs of control.[36] It is quite apparent that the resolution of this issue goes well beyond an inquiry into the role of private philanthropy, but any analysis of private philanthropic activities in this area can properly be made only with an awareness of the larger issue.

The Council on Environmental Quality (the agency in the Executive Office of the President charged with the overall administration of NEPA), the Environmental Protection Agency (the agency charged with the task of dealing with pollution), and most environmentalists take the position that the cost of pollution control should be reflected in the prices of the goods and services involved – that is, the prices paid by consumers should cover the environmental, as well as the production, costs. The objective is accomplished by requiring the person or entity producing the product or service to pay for his or its own pollution control and to pass these costs on in the form of higher prices. The process may be described as "the internalization of external social and environmental costs." The Organization of Economic Cooperation and Development (an organization representing most of the world's developed countries, other than Russia) has endorsed the concept as a principle for all developed nations to follow.

The primary alternative would be to finance pollution control costs out of governmental revenues. This could be accomplished by direct appropriations to public agencies or private persons and/or by the use of tax incentives. To the extent such costs are paid out of general revenues, the prices of the goods and services involved will be lowered and the environmental costs will be borne by all taxpayers. As noted in the next subsection of this report, Congress has already provided substantial public funds for pollution control.

The subject of tax penalties on pollution is also a major topic today. An illustration is the sulfur oxide emissions tax developed by CEQ, EPA, and Treasury in 1971 and sent to Congress in February 1972.[37] The tax would have been imposed on emissions of sulfur oxide causing the air to fail to meet the standards required under the Clean Air Act Amendments of 1970. The tax was intended to make polluting activities more expensive than pollution control (thus forcing compliance with the clean air standards and internalizing the costs thereof) or, alternatively, to compensate the public for environmental damage (and internalizing the costs of such compensation). The proposed tax was never enacted. Aside from the technical problems of accurately measuring emissions, identifying sources, and quantifying costs, the proposal was confronted with the traditional congressional reluctance to employ the tax system to achieve social goals, especially when there already existed specific regulatory authority to achieve the desired goal. Emissions taxes nevertheless continue to have great appeal to environmentalists.

We should also note the role of user charges in the economics of pollution control. There is a widely held view that the charges for governmentally provided services should reflect the full cost of pollution control associated therewith. The principle was reflected in the creation of the Highway Trust Fund which, through the federal gasoline tax, charged the motoring public with a substantial portion of the cost of highway construction. There is today considerable sentiment to utilize these funds to provide mass transportation facilities; the reasoning is that the gasoline tax is a charge for the use of public highways and may appropriately be employed to reduce automobile air pollution by providing less polluting transportation alternatives.

The foregoing are matters far beyond the scope of this paper but which must be held in mind as one considers the role of tax-exempt philanthropic activities in the area of pollution control.

Noncharitable Tax Incentives

Congress has from time to time provided noncharitable tax incentives to encourage pollution control. Such measures are, as explained above, a departure from the basic principle that pollution control costs should be reflected in market prices.

When the general investment credit was suspended in 1966, section 48(h)(12) of the Internal Revenue Code continued the investment credit for air and water pollution control facilities. Section 169 authorizes accelerated (5-year) amortization for control facilities placed in service after 1968 in plants which were in operation before 1969. Interest on bonds issued by corporations chartered under United States statute, including the Environmental Financing Authority,[38] is exempt from federal income tax under section 103(a)(3), and section 103(c)(4)(F) provides the same exemption for state and local obligations issued to finance air and water pollution control facilities (without regard to the limitations applicable generally to industrial development bonds). Finally, the deductions for research and experimental expenditures (section 174) and, to a much more limited extent, for farmers' soil and water conservation expenditures (section 175) may be applicable in certain instances to pollution control expenditures.

Charitable, Educational, and Scientific Activities (Other Than Litigation)

It is impossible for us to survey all environmental groups or to assess the impact of environmental groups on pollution control or other environmental activities. Our interviews and research have, however, developed some information as to the nature and scope of private, including philanthropic, activity in the environmental field.

There are thousands of environmental organizations, many tax exempt under section 501(c) (3) or section 501(c) (4) and many (presumably because of small size or political activities) not exempt. A recent study conducted by CEQ resulted in this conclusion:

> From its genesis in conservation issues, the environmental movement has recently undergone remarkable growth and diversification. To the traditional concerns of wilderness and wildlife preservation have been added the issues of the new environmentalism – pollution, the urban environment, land use, energy policy, and the like. Although environmentalism has developed slowly throughout our history, the period of 1969-70 – culminating around Earth Day – brought a rapid rise in public awareness and involvement in environmental issues. During that period there was an increase in the size of existing organizations and a proliferation of thousands of new ones. While some groups grew, others faltered. It now appears that the movement has stabilized with about twice as many active organizations today as before Earth Day. The great majority are either remaining stable or growing stronger.[39]

There are many national organizations with large memberships (50,000, 100,000 or more), the largest (a section 501(c) (3) organization) reported to have more than 3.5 million members. There are other national organizations that do not seek members. There are 11 regional service centers throughout the country, organized as tax-exempt educational organizations, to increase the effectiveness of local organizations and to assume functions beyond the abilities of smaller groups, such as regular publications, forums and workshops, research, planning assistance, and information and clearinghouse functions. In many areas, small organizations have joined together to form coordinating councils on a state or smaller level to increase the impact of their views, exchange information, and establish a liaison with larger organizations. At the local level there are countless citizen and student groups, as diverse in character and interests as the people comprising their memberships and often arising to deal with specific local interests or issues.

Without distinguishing between exempt and non-exempt organizations, or between section 501(c) (3) and section 501(c) (4) organizations, the following table reflects the results of a 1972 study,[40] prepared for EPA by The National Center For Voluntary Action, of the percentage of environmental organizations engaging in the following major activities:

Activity	Percentage
Information dissemination	65%
Public meetings and discussions	51
Participation in hearings	46
Recycling	23
Legislative research and drafting	19
Lobbying	17
Litigation	7
Protests and demonstrations	2

Bearing in mind that section 501(c) (3) "educational" activity is defined[41] to include instruction of the public on subjects useful to the individual and beneficial to the community, it will be seen that the major portion of the activities described above can qualify under section 501(c) (3). Educational activity encompasses the publication of books, pamphlets, periodicals and research reports, the conduct of public meetings and workshops, TV and radio messages, and the operation of speakers' bureaus. Participation in administrative hearings is a permissible activity of tax-exempt organizations but participation in legislative hearings, except upon request of the legislative body, raises a problem for section 501(c) (3) organizations as explained above in Chapter I of this report. Substantial lobbying activities are prohibited for section 501(c) (3) organizations but may be permissible for a section 501(c) (4) organization. A few organizations are involved directly in politics, including the making of campaign contributions, and this is an activity not permitted under either section 501(c)(3) or section 501(c) (4). While litigation may be an activity engaged in by only 7 percent of all environmental organizations, it raises the primary topic for detailed consideration in this report and the most significant issues for consideration by the Filer Commission (see Chapter IV).

Acquisition of Public Land

The acquisition of land by conservation organizations is a traditionally recognized charitable activity.[42] Our investigation and research have dislcosed no major policy issues with respect to the traditional activity of acquiring (by purchase or gift) land to be held for public benefit but have indicated certain problem areas about which some concern has been expressed.

Role of Private Organizations

Section 501(c) (3) organizations have long engaged in the practice of acquiring land, by purchase or tax-deductible gift, and holding the same for some public use or for the preservation of wilderness unaffected by man. In more recent times there has been an increasing trend toward the acquisition of land for resale to governmental agencies, federal, state, or local. The advantages are seen as expert assistance in the identification of desirable public land, flexibility in acquisition methods, and the ability to move quickly to prevent development or to avoid speculative increases in land prices.

In the view of some conservationists, these advantages highlight a larger problem – the inflexible and archaic method of governmental land acquisition. The nearly universal governmental method is for the legislative body to appropriate funds for a specific purchase and for the administrative agency then to attempt to purchase the land for cash. Aside from the time delay necessarily involved, the advance notice and publicity provide ample opportunity for speculators (or, worse yet, persons with inside information) to step in, purchase part or all of the land in question and realize a profit at taxpayers' expense. Many conservationists believe that the time has come to develop entirely new methods of land acquisition, particularly since undeveloped land is a commodity in diminishing supply.

Conservation organizations are therefore taking the initiative in identifying and acquiring desirable land, sometimes with advance governmental cooperation and sometimes entirely on their own, and then holding the land for resale to the government (at the government's appraised value) when the time-consuming governmental procedures have been completed. Some organizations have developed considerable experience and expertise which has enabled them to act as land acquisition consultants to governmental agencies, particularly at the state and local levels, and to develop and experiment with new methods of acquisition.

The Effect of Uncertainties

If one accepts the proposition that there is a pressing need for more flexibility in, and the development of new methods of, public land acquisition, then there is a corresponding need to attract private and public capital for innovative ventures. It is complained, however, that the tax laws impose restraints on innovation, but it has not been found by us that the restraints are more than those required to confine charitable organization activity to proper tax-exempt purposes. The problem facing conservationists is essentially one of dealing with uncertainties, that is, the application of broad tax principles to new and experimental activities.

More detailed published regulations would likely add to, rather than solve, the uncertainties since it is impossible to anticipate in advance every situation that might arise in the future. The advance IRS ruling process is not a completely satisfactory solution because of the expense and time delay involved. It has been suggested that a new federal agency could be structured to respond quickly to charities' needs and even to provide expanded services, such as management consulting advice. This is a topic, however, that goes beyond the scope of our report; and the question of a separate agency for exempt organizations is the subject of a separate report to the Commission (see David Ginsburg, Lee R. Marks, and Ronald P. Wertheim, "Federal Oversight of Private Philanthropy").

Tax Status of Gains on Resale

While some concern has been expressed to us concerning the tax status of gains realized on the sale of land to a government, present law appears to deal adequately with the subject. Such gains can arise from appreciation in value occurring during an organization's holding period or can result from the organization's having acquired the land in whole or in part by gift (with a carryover of the donor's low tax basis). To our knowledge no one questions that the acquisition and resale of land for public use is a proper activity for a section 501(c) (3) charitable organization. Gains realized from such activity therefore qualify, in tax lawyers' parlance, as "exempt function income" (as contrasted with "unrelated business taxable income" which is made taxable by section 511).

Income from the performance of an exempt function comes squarely within the tax exemption granted by section 501(c) (3). Even if in a particular case the land were properly categorized as investment property, gains arising from investment transactions are not subject to tax (except in the case of a private foundation which is subject to the 4 percent excise tax imposed by section 4940 on investment income). For purposes of determining whether an organization is a private foundation or a public charity, the gains must also be categorized in order to apply section 170(b)(1)(A)(vi) (defining publicly supported charities) and/or section 509(a)(2) (defining broadly supported charities). However, a determination that a particular gain is exempt function income, or is investment income, is all that is required for purposes of applying these rules.

Tax Status of Income From Excess Land and Commercial Property

Initiative and aggressiveness in the acquisition of public land have led to many situations in which, to acquire the desired land, a charitable organization has been required to purchase (or accept a gift of) excess land ("excess" in the sense of additional, unwanted acreage) and/or commercially developed land. For example, the organization might desire a 10-acre parcel as a park site but can acquire it only by acquiring the owner's entire 100-acre tract. Or a desirable neighborhood playground site might be presently occupied by a gasoline station or other commercial enterprise. The status of income from, and gains on the resale of, excess land or commercial property raise some problems, but all seem to be resolvable within the framework of existing law.

If the purpose of an acquisition is related to the organization's exempt functions, it seems clear that no problem will arise under section 501(c) (3). The real problem is under section 512 – is the income or gain derived from an unrelated business?[43] If excess land is held merely until a buyer is found it appears to us that any resulting gain is, at worst, investment income, not unrelated business income. On the other hand, if the organization engages in significant development activities or otherwise acts as a "real estate dealer," it would likely be held to be engaged in an unrelated business. In between are many gray areas. Similarly, commercial real estate holdings raise the section 512 issue. Continued operation of the gas station postulated above, pending conversion into a playground or sale to a governmental agency, would likely give rise to unrelated business income, but this means merely that the net income would be subject to income tax under the provisions of section 511. Gain resulting from appreciation of land would seem to be the direct result of an exempt function and therefore would not constitute unrelated business income.

The foregoing are technical problems of the type which arise all the time under the tax laws and do not seem to raise major policy issues for consideration by the Commission.

Tax Status of Consulting Fees

Because of their expertise, conservation organizations are in a position to render valuable advice to governmental agencies and private persons on the subject of passing land into the public domain. When advice is valuable it is reasonable for the recipient to pay for it.

Consulting fees or other payments from a government to a charity for the rendition of services related to public functions are closely akin to the many other types of government contract payments made to charities for the performance of public functions, nearly all of which raise no problem under section 501(c) (3) or section 512 so long as the service rendered by the charity is related to its exempt purposes. Because there is no underlying principle requiring all charitable activities to be free, income from services rendered to a government should qualify as exempt function income when the service is related to the organization's exempt purposes (and assisting a government in carrying out public functions is an exempt purpose).

Consulting fees from private persons raise a different question in terms of section 512. Assistance to a private person is not a charitable activity unless the person is a proper object of charity. Compensation for assistance to a profitable business entity, consisting of advice on tax planning for a donation or bargain sale of land to a government for public purposes, may achieve an exempt purpose (in having desirable land pass into the public domain) but also results directly from the rendering of service (tax planning advice) of a type rendered by many taxpaying sources.

Again, the foregoing are technical problems arising under section 512 and it is not the purpose of this report to attempt to solve all such problems. Such as do exist with respect to consulting fees appear to be soluble within the principles of present law without raising policy issues requiring the Commission's attention.

Effect of Charitable Activity on Market Prices

Assessing the impact on market prices of the acquisition activities of tax-exempt organizations is essentially an economic, not a legal, matter. Our comments therefore reflect information conveyed to us rather than the result of legal study and analysis.

Conservationists involved in the acquisition of land for public purposes uniformly believe that their activities are insignificant in the overall economic picture of the country.** Even the very largest organizations lack the financial resources to compete for really substantial (multi-million dollar) properties. In most cases conservation organizations enter the market as bargain purchasers, rather than fair market value purchasers. Such activities do, however, create an incentive for the seller-donor to have the value determined as high as possible to maximize the charitable contribution element of his bargain sale.

Certain controls are built into the acquisition-resale process in that (1) on resales to a government, the purchasing agency is not likely to deal with an organization that consistently pays too much for property and (2) an organization may lose its public financial support if it consistently overpays in its acquisitions. Finally, it has been suggested that the federal government probably has far more effect on land prices than anyone else simply because it has no incentive to buy cheaply and is one of the largest purchasers of land.

Charitable Contributions Deductions for Gifts of Scenic Easements

"Scenic easement" is not a term of art anywhere defined with precision. It is therefore appropriate at the outset to describe what we mean when we use the term in this report.

Meaning of "Scenic Easement"

The term "scenic easement" is used herein in a very broad, non-legal sense, merely as a convenient term to describe a broad range of real estate transactions by which certain rights and burdens may be created to achieve what the parties regard as an environmental benefit with respect to particular land. We prefer to explain our use of the phrase in terms of three basic characteristics: the holder of the benefit, the nature of the benefit, and the alternative legal forms by which the benefit may be created.

The holder of the benefit. The holder of the benefit can be a governmental agency, a charitable organization or a trustee or other person who holds the legal rights for the benefit of a government, a charity, or the public.

The nature of the benefit. Generally speaking, "scenic easements" may be divided into two categories:

1. Imposition of negative restrictions. An easement (or other legal relationship) may restrict the owner's use of the subject land, such as by requiring him to refrain

from certain acts or to continue certain conduct or acts. In such cases the holder of the easement does not have active rights but does have the power to compel the owner to adhere to the terms of the restrictions. The extreme example is an easement requiring the owner to maintain the land in its natural state forever without permitting anyone to gain entry to the property (except, perphaps, for scientists who may be permitted to make occasional entry). There are countless types of lesser restrictions, such as a prohibition against the cutting of trees or a prohibition against the erection of buildings or certain types of buildings or a requirement that the land be used only for farming.

2. Conveyance of affirmative rights. A conveyance may give the holder active rights with respect to the property, such as the right to use the property for scientific purposes or to operate it as a public park. The conveyance may take the form of a transfer to the holder of fee simple ownership, subject only to certain limitations as to the use of the land (or a retained right in the original owner to continue to make certain uses of the land, such as farming or hiking), or the conveyance may be in the form of an easement authorizing the holder to enter upon the owner's land to conduct the activities specified in the document creating the easement. Another alternative is for the owner to convey the development rights to the holder so that the owner and his successors no longer have the power to develop the property.

Alternative legal forms. We have been using the word "easement" which, in semilegal language, may be defined as the privilege of one person (the person to whom the easement runs) to make some use of the land subject to the easement, thereby limiting the usual possessory rights of the owner of the land.[45] Easements may be considered "appurtenant" (that is, the rights granted by the easement are combined with the ownership rights in other land adjoining or nearby the subject land) or "in gross" (that is, the rights are personal to the holder and are not associated with any other land holdings of the holder). Significant legal consequences may turn on whether an easement is appurtenant or in gross, but an examination of these consequences is not necessary for an understanding of the tax issues to be considered. Finally, it must be explained that easements are merely one of many legal tools – conservation benefits may be created by the use of trusts, leaseholds, covenants, equitable servitudes, rights of entry and reversionary interests, some of which create legal "interests in land" and others of which do not.[46]

There are no uniform rules (or even definitions) for all 50 states. There are many new state statutes that may come into play.[47] Owners of land have enormously broad discretion to create legal relationships and private laws with respect to land use, any of which may last forever or for a period of years (which may be fixed in number or measured by one or more lives). The important point is that a private person has the power to convey something less than 100 percent of his property interests to or for the benefit of a charitable organization or a governmental body, and that which he has conveyed has some value; we intend to use the term "scenic easement" to encompass all the arrangements by which such conveyances may be made.

Deductibility of Gifts of Scenic Easements

The fair market value of property given to a charitable organization (or a governmental agency for public purposes) normally qualifies as a charitable contribution and is deductible for federal income tax purposes within the limits prescribed in section 170. Gifts of scenic easements, however, are gifts of less than all of an owner's interest. Section 170(f) (3) limits the deductibility of gifts of partial interests to certain specified types of partial interests, and the only deductible type relevant to scenic easments is "an undivided portion" of the owner's entire interest. The regulations provide that "An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[48] However, the regulations go on to provide that the term includes "an open space easement in gross in perpetuity" and explain:

> . . . For this purpose an easement in gross is a mere personal interest in, or right to use, the land of another; it is not supported by a dominant estate but is attached to, and vested in, the person to whom it is granted. Thus, for example, a deduction is allowed under section 170 for the value of a restrictive easement gratuitously conveyed to the United States in perpetuity whereby the donor agrees to certain restrictions on the use of his property, such as, restrictions on the type and height of buildings that may be erected, the removal of trees, the erection of utility lines, the dumping of trash, and the use of signs.[49]

In a recent ruling[50] the IRS explained that such an open space easement may be valued, for charitable contribution deduction purposes, by the "before and after" approach – that is, the value of the donated easement is the value of the property immediately before the creation of the easement, less the value of the property after it has become subject to the easement. This ruling was the product of more than two years' work by Treasury, CEQ, and others but is still limited in scope to the open space easement described in the regulations. Significantly, the regulations[51] also contain the statement that "a charitable contribution in perpetuity of an interest in property not in trust where the donor transfers some specific rights and retains other substantial rights will not be considered a contribution of an undivided portion of the donor's entire interest in property. . . ."

The rule last quoted appears to bar a deduction for a gift of most types of scenic easements, except an "open space easement in gross in perpetuity" or a conveyance in which the donor has retained only insubstantial rights.

The present state of the law, as set forth in the regulations, may be traced to the legislative history of section 170(f) (3) which was added to the Internal Revenue Code by the Tax Reform Act of 1969.[52] The House bill (H.R. 13270) would have disallowed a deduction for any charitable contribution of a partial interest in property except to the extent the interest satisfied new rules relating to deductible interests in trusts (for example, the new rules on charitable remainder unitrusts and annuity trusts). The Senate Finance Committee carved out two exceptions to allow a deduction for a contribution of a remainder interest in real property or "an undivided portion of an entire interest in property," explaining, as to the latter exception, that it was made "to insure that it [the House bill] will not result in the denial of a deduction where an outright gift is made of an undivided (e.g., one-fourth) interest in property."[53] The Conference Committee made certain modifications to section 170(f) (3), not here relevant, and the committee's report contained the following paragraph:

> The conferees on the part of both Houses intend that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity.[54]

As explained above, the regulations limit deductions for contributions of scenic easements to the one, rather narrow situation described in the Conference Committee Report.

Issues and Problems With Respect to Scenic Easements

The primary policy issue is whether deductions should be allowed for charitable contributions of scenic easements and, if so, whether the deductions should be limited to "open space easements in gross in perpetuity." A second question is whether the income tax charitable deduction should be treated differently from the gift and estate tax charitable deductions. Finally, there are administrative problems with respect to the valuation of scenic easements. These three areas are considered separately.

Should contributions of scenic easements be deductible? Congress' basic concerns in enacting section 170(f) (3) appear to have been related to tax "equity" and assurances that charity would actually receive that for which a deduction was to be allowed. Thus, it was perceived to be an inequitable double tax benefit to allow a donor an income tax deduction upon the creation of a trust which would pay the income to charity for a period of time (a "charitable term trust") when, as a result of creating the trust, the income therefrom would no longer be includable in the donor's gross income.[55] The result was present section 170(f) (2) (B) which allows a charitable deduction for a charitable term trust only when the donor must report the trust income on his own return during the charitable term.

It was also believed that the allowance of a charitable deduction for remainder interests in trusts was subject to abuse because charity ultimately might not receive the amount for which a deduction was allowed to the donor upon the creation of the trust.[56] Congress therefore provided in section 170(f) (2) (A) that gifts of remainder interests would be deductible only in the case of trusts which can make payments to non-charitable beneficiaries in the form of fixed-dollar annuities or fixed-percentage unitrust amounts or in the case of pooled income funds maintained by charitable organizations.

Finally, it was concluded that a gift to charity of the right to use property also resulted in an unfair double tax benefit (exclusion of the income that would otherwise be collected plus a deduction for the fair rental value of the use donated to charity)[57] and the Ways and Means Committee therefore proposed a provision (which became section 170(f) (3)) to allow deductions for gifts of less than a taxpayer's entire interest in property only to the extent a deduction would be allowed had the transfer been made in trust and to make clear that a contribution of the use of property would not be deductible.

As noted earlier, the Senate Finance Committee added provisions to allow deductions for gifts of remainder interests in real property and undivided interests in property. The Conference Committee accepted the Senate Finance Committee's amendments but restricted the deduction for gifts of remainder interests in real property to remainder interests in "a personal residence or farm."[58]

In summary, then, the congressional purposes underlying section 170(f) (3) were to (1) eliminate the double tax benefits flowing from gifts involving the donor's avoidance of income produced by the property in question, coupled with a deduction for the value of the interest given to charity, and (2) insure that charity will ultimately receive the amount for which a deduction is allowable by limiting deductibility to gifts of partial interests meeting the detailed standards of the new trust rules or partial interests of a type in which charity receives an immediate interest or a future interest which is not likely to be diverted from charity.[59]

The reason for limiting deductible remainder interests to interests in personal residences and farms was not explained by the Conference Committee, but it may be assumed that there was opposition to deductions for future interests in commercial real property (unless the new trust rules were satisfied) and considerable support for the charitable disposition of residences and farms. The reference in the Conference Report to certain "open space easements" was quite obviously a last minute item called to the conferees' attention by interested persons.

Judged against the backdrop of the congressional purposes underlying the provisions of section 170(f)(2), (3) and (4), the following conclusions may be drawn with respect to charitable contributions of scenic easements:

1. A scenic easement restricting the use of property for a limited period of time (for example, a fixed number of years or the lifetime of a named individual) would be similar to a charitable gift of the right to use property for a limited time and could result in the kind of double tax benefit with which Congress was concerned. On the

other hand, the conveyance of a perpetual easement is the permanent transfer of a portion of the property, and Congress was prepared to accept such transfers (that is, undivided interests) as deductible charitable contributions.

2. The limitation of deductions to scenic easements "in gross" is strange in the context of the charitable purposes to be accomplished and the congressional concern with assurances that charity will receive the amount for which a deduction is to be allowed. A great many (perhaps most) scenic easements are created on land neighboring other land owned by a charity or a government, and the easement is "appurtenant" to such other land (the "dominant estate"). Generally, if the dominant estate is transferred (as can happen upon the liquidation or merger of the charitable owner), the successor owner of the dominant estate acquires all the rights of the scenic easement. In many jurisdictions, an easement "in gross" is not transferable with the result that it may not represent a permanent charitable interest or may restrict desirable flexibility in the administration of the easement.

3. There appears to be no good reason for limiting charitable deductions to gifts of "easements" when there are many other legal devices for creating charitable interests that are just as permanent and valuable. We submit that rules relating to charitable deductions for scenic easements should be drawn with reference to the nature and permanency of the charitable benefit rather than the particular legal technique employed to confer the benefit.

In 1973 the administration proposed to Congress an "Environmental Protection Tax Act,"[60] one provision of which would have amended section 170(f) (3) to permit deductions for leases, purchase options and easements of not less than 30 years duration, and remainder interests in real property, when such interests are conveyed to charitable organizations "exclusively for conservation purposes." The term "conservation purposes" was defined to mean (1) the preservation of land areas for public outdoor recreation, education, or scenic enjoyment, (2) the preservation of historically important land areas or structures, or (3) the protection of natural environmental systems. The proposal was formulated by the Council on Environmental Quality and reflects the council's concern with the need to encourage conservation and with the restrictive nature of present law.

We believe the Filer Commission should consider whether, as a policy matter, it is desirable to recognize gifts of scenic easements as charitable contributions and, if so, whether the recognition should be narrowly restricted to gifts of "easements in gross in perpetuity." In this regard we should point out that outright gifts of land to public bodies and charitable organizations have long been recognized as charitable contributions, and gifts of scenic easements can create public benefits having a value just as real as the value of outright gifts.

Distinctions between income tax deductions and gift and estate tax deductions. As already noted, the gift tax (section 2522(c)) and estate tax (section 2055(e)) charitable deductions follow the income tax rules with respect to the deductibility of gifts of scenic easements. From an analytical point of view the need for parallel treatment is questionable. The income tax deduction provides a tax benefit against a person's taxable income receipts for a gift he has carved out of his land, and in the usual case there is no functional relationship between the income and the land. On the other hand, the gift and estate taxes are taxes imposed on the transfer of property, and the charitable deductions under these laws are merely devices for rendering transfers to charity exempt from the transfer taxes.

A gift of an "easement in gross in perpetuity" is only one means of transferring something of value to charity. Why such interests should be exempt from the transfer taxes while other scenic easements of equally significant value should be taxable is not at all apparent to us. We believe the Commission should consider whether the exemption (that is, the gift and estate tax charitable deductions) should not apply equally to all transfers of scenic easements to charity because, regardless of the length or quality of the charitable interest transferred, to the extent it has measurable value it is the type of transfer which has traditionally not been subjected to the transfer taxes.

Administrative problems. The principal administrative problems encountered in connection with gifts of scenic easements revolve around the value of the interests donated to charity. In most, if not all, cases a taxpayer will have to be prepared to support his claimed deduction with an appraisal by a competent appraiser. Because of the unusual nature of the partial interests involved, such appraisals can be expensive and not all persons qualified to express opinions on the value of fee simple interests are necessarily competent to judge the value of scenic easements. In addition to the expense (and often the delay) in obtaining competent appraisals, a taxpayer faces considerable uncertainty in making a gift of a scenic easement. He cannot determine the economic or tax effects of a proposed gift until an appraisal is completed, and on audit of his tax return there is a wide area for disagreement between the taxpayer and the IRS as to value.

We are not at all sure that the problems of valuing scenic easements can readily be alleviated. One possible solution would be to create a commission, consisting of federal employees experienced in land acquisition and appraisals and members of conservation organizations and the real estate profession, and to authorize the commission to rule in advance of a transaction on the value of the interest involved and, at the election of the donor, to have the ruling binding on the donor and the IRS for tax purposes. Such a procedure would appear to be suitable for gifts to the United States and for gifts to charitable organizations; for gifts to state or local governments it might be desirable (although not always practical) to require the concurrence of the donee government in the valuation. The primary objection to the procedure is that it would shift to the federal government the burden and expense of most such appraisal work unless the commission itself were granted tax-exempt status and could collect contributions from private sources.

It has also been suggested that the IRS could publish a schedule of values for particular types of interests, or at least a schedule of minimum values, but the simplicity of such an arrangement would likely be more than offset by the fact that land by nature is not a fungible commodity and has no uniform market value.

Finally, it should be noted that a gift of a scenic easement may result in enhancement to the value of other land owned by the donor. Thus, for example, an individual owning a home might make his home more valuable by granting a scenic easement on an adjacent or nearby parcel. This problem is, however, an essentially factual matter depending on the circumstances of the particular case and should be soluble within the framework of existing law. The solution appears to lie in determining the value of the scenic easement conveyed in light of the value of all the property owned by the donor at the time of the conveyance.

IV

PUBLIC INTEREST LITIGATION

This part of our report focuses on "public interest litigation," of which environmental litigation is a major component. The first section describes at some length the trans-Alaska pipeline case, which raises so many of the issues found in public interest litigation that it is unique in its breadth (as well as its economic magnitude), and the second section is a detailed examination of public interest litigation.

At the outset it should be observed that the term "public interest litigation" is not particularly descriptive of all the activities usually encompassed by the term. "Litigation," for example, includes all forms of proceedings before governmental administrative agencies and is not limited to controversies tried before the courts. "Public interest" is, in a sense, a misnomer because public interest lawyers are advocates for the special interests of their clients and are not advocates for some abstract concept of "the public interest." These matters are explored below in the second section and are mentioned here merely to alert the reader to the scope of the term as used in this report.

Environmental Litigation Illustrated – the TAPS Case

The trans-Alaska pipeline case is fascinating because it illustrates so many of the issues arising in public interest environmental litigation and because, in terms of consequences, it may well be the largest environmental case ever litigated. Involved were (1) oil reserves on the Alaska North Slope valued at billions of dollars, (2) expenses of development and marketing of hundreds of millions of dollars, (3) an acute national energy shortage, (4) substantial international relations and foreign policy issues, (5) rights of non-white minorities, (6) the potential for severe damage to the Alaskan fishing industry, and (7) the preservation of this country's last remaining vast wilderness area. The resolution of the case has required major action by a dozen or more agencies of the executive branch of the government, by the federal courts and by the Congress.

Background

In 1968 several oil companies made a major oil strike on the North Slope of Alaska. Three oil companies and the pipeline subsidiaries of five other oil companies formed an association known as the Trans Alaska Pipe Line System, or TAPS, to act as agent for the exploration of the development of the oil field and the marketing of the products. After completion of the initial studies, including the testing of an ice-breaking tanker sent into the Arctic Ocean, TAPS concluded that a large diameter pipeline across Alaska to Valdez, an ice-free port on the Gulf of Alaska, and the use of tankers sailing to West Coast ports represented the most practical means of bringing the crude oil to market.

On April 18, 1969, Walter J. Hickel, Secretary of the Interior, established the North Slope Task Force within the department to study the myriad of problems which were likely to arise. At the President's request in May of the same year the task force was enlarged to include many other government agencies. In June TAPS applied to Secretary Hickel for the following permits: (1) a 54'-wide pipeline right-of-way from Valdez to Prudhoe Bay on the Arctic North Coast, a distance of nearly 800 miles; (2) an additional 46'-wide right-of-way parallel and adjacent to the pipeline right-of-way for construction purposes; (3) an additional 100'-wide right-of-way for a construction road from Prudhoe Bay to Livengood, a town near the Yukon River and a point somewhat less than half way to Valdez.

TAPS also requested more than 12 million cubic yards of gravel from public land for use in the construction of the pipeline and the road. It also applied to the Department of Agriculture for a special land-use permit (a "SLUP") for an oil tank farm on 802 acres of land in the Chugach National Forest.

On September 15, 1969, the task force submitted a preliminary report to the President outlining the problems anticipated in the development of the pipeline. On October 1, the Forest Service of the Department of Agriculture issued the tank farm SLUP. In December TAPS amended its pending application to request a single right-of-way 54' in width and submitted two separate applications for SLUP's, one for additional access and construction space extending 11' on one side and 35' on the opposite side of the pipeline right-of-way and the other for an area 200' in width for the pipeline construction surface and a haul road to run from Prudhoe Bay to Livengood.

In early 1970 the oil companies organized Alyeska Pipeline Service Co. to take over the engineering design and construction responsibilities of TAPS. Soon thereafter, Secretary Hickel announced his intention to grant the requested right-of-way and SLUP's.

It is to be noted that up to this point in time the primary input into the decisionmaking process came from the oil companies. That this was so is understandable because they were, after all, the source of the capital to be invested in the project.

Litigation

On March 26, 1970, three environmental organizations, The Wilderness Society, Friends of the Earth, and Environmental Defense Fund, filed suit in federal court in the District of Columbia to enjoin Secretary Hickel from issuing the necessary permits and for declaratory relief. Plaintiffs were represented by lawyers from Center for Law and Social Policy, itself a tax-exempt public interest law firm. Plaintiffs contended that the issuance of the permits would violate section 28 of the Mineral Leasing Act of 1920, that the tank farm SLUP violated the acreage limitation of the applicable law, and that the issuance of any permit or right-of-way would violate NEPA. While the suit involved many technical issues plaintiffs' primary concern was, of course, focused on the environmental impact of a trans-Alaska pipeline.

On April 3, 1970, the district court denied a temporary restraining order, but on April 28 the court handed down a two-page opinion granting a preliminary injunction against Secretary Hickel. *Wilderness Society* v. *Hickel*, 325 F.Supp. 422 (D.C., D.C. 1970). The court concluded that the three basic applications should be treated as a single application for a pipeline right-of-way and that, as so viewed, the Secretary had failed to comply fully with NEPA and the right-of-way exceeded the width limitations of section 28 of the Minearal Leasing Act of 1920.

Executive Action

The focus then shifted to the executive branch as the Department of the Interior and numerous other government agencies set about preparing the detailed environmental impact statement required by NEPA. Several task forces were formed to study various aspects of the proposed trans-Alaska pipeline and alternatives thereto. It was not until January 1971, however, that a draft of the impact statement was issued. Thereafter public hearings on the draft were held in Washington and Alaska.

During this phase of the proceedings, the environmental organizations and the public interest lawyers had the opportunity to offer their contribution on the merits of the project. Their role was to present expert testimony and other evidence that might not otherwise have been considered. Their input and critique of the draft impact statement lead to extensive revision of the statement and in the plans for the project.

On March 3, 1971, Alyeska filed an application for rights-of-way for 26 microwave communications sites along the pipeline route. In June of the same year the State of Alaska contracted with Alyeska to have Alyeska build a public highway from Livengood to Prudhoe Bay, along a route almost identical to the 200' haul road requested in one of the SLUP applications, and Alaska agreed to secure the necessary permits. Soon thereafter Alaska applied to the Bureau of Land Management for a permanent highway right-of-way and Alyeska then withdrew its SLUP application for the haul road. Alyeska also submitted applications to the Department of the Interior for a 20-year lease to construct three airports along the pipeline route and contracted with Alyeska to have them built and operated as public airports during construction of the pipeline. Alaska also applied for free-use permits for gravel to be used in construction of the highways and airports.

On February 4, 1972, Alyeska (1) amended its construction SLUP application to request the use of such land "as may be reasonably necessary" for construction and (2) filed an amended application requesting rights-of-way for 10 pumping stations. On March 20, 1972, nearly two years after the issuance of the preliminary injunction, the

Secretary of the Interior issued a Final Impact Statement — a six-volume work representing the combined efforts of the Departments of Interior, Defense (including the Corps of Engineers), Transportation, H.E.W., and Housing and Urban Development and the Office of Science and Technology, the Council on Environmental Quality, and the EPA. This was followed on May 11 by a news release in which the then-Secretary, Rogers C. B. Morton, announced his intention to grant the necessary permits for the proposed pipeline.

Return to the Courts

The matter returned to court where the parties then included the State of Alaska, Alyeska, and certain Canadian environmentalists (including a member of the Canadian Parliament). After a hearing on whether the preliminary injunction should be made permanent, the District Court on August 15, 1972, dissolved the preliminary injunction, denied a permanent injunction, and dismissed the complaints. The plaintiffs promptly appealed to the Court of Appeals for the District of Columbia Circuit.

The matter was heard and decided by seven judges of the court of appeals, sitting en banc. See *Wilderness Society* v. *Morton*, 479 F.2d 842 (D.C. Cir. 1973), cert. den., 411 U.S. 917 (1973).

In the opinion handed down on February 9, 1973, the court held that the construction of the trans-Alaska pipeline must be halted. While the plaintiffs were most concerned about environmental issues, the court's decision turned on a narrow technical ground. Everyone had agreed that the basic 54' pipeline right-of-way was authorized by law, but the court held that the width limitation of section 28 (limiting a right-of-way to the width of the pipe plus 25' on each side) applied to all land necessary for construction, as well as maintenance and operation, that the construction SLUP was an integral part of the pipeline right-of-way, and that the total right-of-way violated section 28 and the regulations of the Bureau of Land Management. The court found valid the issuance of the requested permits for pumping stations, communication facilities, the Valdez tank farm and Alaska's highway, airports and free use of gravel. The court, however, in a 4-to-3 decision, declined to determine whether the requirements of NEPA had been satisfied. The effect of the court's decision was to place the future of the Alaskan pipeline in the hands of Congress.

Congressional Resolution

In mid-February 1973 the President delivered his Environment and National Resources State of the Union Message. Part of the program announced at that time included two bills which, on February 27, were sent to the Senate. These bills would have extensively rewritten the statutes relating to the management of public lands and the leasing of mineral rights. Portions of the bills would also have expanded the authority of the Secretary of the Interior to issue rights-of-way for the trans-Alaska pipeline. These bills, along with two others dealing specifically with Alaskan oil, were referred to the Senate Interior and Insular Affairs Committee, chaired by Senator Jackson (Washington). On March 9 and March 27 the committee held hearings on those portions of the bills relating to the granting of rights-of-way for the construction of large oil and gas pipelines and other transportation facilities across federal lands. Thereafter, the committee had extensive communications with numerous federal agencies to develop additional information pertinent to their inquiries. In the meantime, on April 2, 1973, the Supreme Court of the United States announced its refusal to review the court of appeals decision.

On May 2 and 3, 1973, the committee held hearings on three bills dealing specifically with a trans-Alaska pipeline and its alternative, a trans-Canada pipeline.

On May 9, 1973, the committee reported favorably a bill (S. 1081). Basically, this bill would have increased the authority of the Secretary of the Interior to grant various types of rights-of-way and spelled out the procedures and limitations applicable thereto. In addition, Title II would have requested the President to undertake negotiations and other actions with respect to a trans-Canada pipeline; the bill provided, however, that it was the expectation of Congress that the Alaskan pipeline would be built first and that this provision of the bill was not to affect the decision on such a pipeline nor to impose any additional requirements under NEPA. In its report the committee described the areas of controversy as being essentially the following: (1) the environmental impact (basically the question of the Alaskan route versus the Canadian route, but focusing also on potential marine pollution and numerous other environmental concerns), (2) the question of markets (delivery of the oil to the West Coast versus delivery to the Midwest), (3) the relative economic benefits (that is, market prices) of an Alaskan pipeline compared with a Canadian pipeline, (4) ownership and control (in view of Canadian statements that nationals of Canada would have to own and control at least 51 percent of any Canadian facilities), and (5) numerous other issues, including scheduling and timing of various alternatives, the problems of financing, the impact on the U.S. balance of payments, the physical security of the pipeline, employment and other economic effects within Alaska, and the impact on competition and market power. In the end, however, the committee concluded that the principal controversy was between a 48" pipeline through Alaska versus a 48" pipeline through Canada. The advocates of the Alaskan pipeline were the oil companies, industry and trade associations, and the respective administrations of Alaska and the U.S. government. The principal advocates of the Canadian pipeline were conservation organizations, commercial fishermen groups, state officials and Congressmen from the Midwest, academicians, and Canadian interests. The committee itself concluded that the Alaskan pipeline was preferable on the ground that it could be on stream from two to six years earlier than a Canadian line.

The critical day from the environmentalists' point of view was July 17, 1973, when S. 1081 was taken up on the floor of the Senate. A number of amendments were considered that day, but perhaps the most important was one offered by Senator Gravel (Alaska). He proposed an amendment to add several provisions to the bill in effect directing the Secretary of the Interior and other federal agencies to issue all necessary permits for a trans-Alaska pipeline as described in the Final Impact Statement, declaring that all previous actions by government officials "shall be regarded as satisfactory compliance" with NEPA, declaring that no further action under NEPA would be required, and limiting judicial review of the statute and governmental actions with respect to the proposed pipeline. In a roll call vote the amendment was approved by the narrowest of margins – 49 to 48. Opponents of the bill then sought to overturn the approval of the amendment. On the critical roll call vote the Senate divided evenly, 49 to 49. The Vice-President then cast the deciding vote approving the amendment. Shortly thereafter the bill as amended was approved by the Senate, 77 to 20.

During the congressional phase of the TAPS case, the lobbying prohibition was strongly felt by the section 501(c) (3) environmental and public interest law organizations. Business corporations could present their views to legislators and the public, but charitable corporations could not do so in a "substantial" way. When the vote of one Senator could have reversed the outcome, the ability of charitable organizations to have lobbied directly with legislators could conceivably have altered the result.

After Senate approval the bill had relatively smooth sailing. The House passed a similar measure on August 2. A Senate-House Conference Committee worked out a final bill which overwhelmingly passed the House on November 12 and the Senate on November 13 and was signed by the President on November 16, 1973.

As enacted, the new law[61] completely rewrote section 28 of the Mineral Leasing Act of 1920 to provide for the issuance of rights-of-way, SLUP's and other permits, supplying definitions and imposing various limitations thereon. Title II dealt specifically with the trans-Alaska pipeline. This Title, known as the "Trans-Alaska Pipeline Authorization Act," specifically directed the issuance of all necessary permits and authorizations necessary for the construction, operation and maintenance of the trans-Alaska pipeline system as generally described in the Final Impact Statement, declared that the foregoing action "shall be taken without further action" under NEPA, provided that judicial review of such actions could be had only by a suit filed within 60 days after enactment of the statute, provided for the liability of any permit holder and of persons transporting oil sent through the pipeline, and requested the President to enter into negotiations with the government of Canada concerning the desirability and feasibility of one or more oil or gas pipelines through Canada.

In the face of such a strongly worded statute, it was apparently thought that little could be accomplished by additional litigation, and no suit was filed within 60 days of the enactment of the statute. The pending case was voluntarily dismissed on January 16, 1974. Thus, the way was paved for the Alaskan pipeline to become a reality.

Legal Fees

Following the dismissal of the action on the merits, the plaintiff organizations requested the circuit court to award them their expenses and attorneys' fees. In a 4 to 3 decision the court (1) awarded plaintiffs' expenses and costs equally against Alyeska, the State of Alaska, and the United States, as authorized by statute, and (2) approved the award of attorneys' fees, the amounts thereof to be determined on remand to the district court.[62]

The majority noted that the traditional American rule is not to award attorneys' fees against the losing party in a law suit but that the courts have broad equitable powers to make such awards in appropriate cases. One such exception to the general rule is the case where the plaintiff has acted as a "private attorney general," vindicating an important public policy. The majority concluded that the plaintiffs succeeded in their role as a private attorney general protecting vital statutory interests. In support of this conclusion they pointed out that, as a result of the suit, Congress amended the Mineral Leasing Act of 1920 and added thereto several important new requirements and restrictions. They also concluded that the NEPA issue, although not decided by the court, further supported the award of attorneys' fees. They cited comments by the Honorable Russell E. Train, then (June 29, 1973) chairman of the Council on Environmental Quality and now administrator of EPA, to the effect that the litigation forced serious study of many environmental, engineering, and siting problems not adequately considered in the initial proposal presented to the Department of Interior in 1969. The majority held that an award of fees may be appropriate where the "litigation serves as a catalyst to effect change and thereby achieves a valuable public service."

The court directed the lower court to determine the amount of the fees and to assess one half of such amount against Alyeska on the ground that it was the real party in interest in the litigation. The other half would have been assessed against the United States except for the statutory bar to the award of fees against the United States. The court said an award of fees against the State of Alaska would not be appropriate because the state voluntarily participated in the suit to present a different version of the public interest implications of the trans-Alaska pipeline.

Finally, and significantly, the court held that from the award the plaintiff organizations should be reimbursed for payments made by them to their counsel. The balance of the award is to be paid directly to the counsel, rather than the organizations which pay their salaries, to avoid a problem whether such organizations, if they were to be paid, might be engaged in the unauthorized practice of law. The court noted that, in equity, the attorneys should reimburse their employers for the employers' out-of-pocket expenses and that the rest of the award is to belong to the attorneys.

Three judges vigorously dissented and two separate dissenting opinions were filed. One judge construed the action of Congress as a total rejection of plaintiffs' arguments on the NEPA issue and a slap at the court for failing to decide that issue in the first instance. In his view the main thrust of the NEPA claim would have subjected a vital part of our energy supplies to the future control of a foreign government, thus defeating the goal of making the nation self-sufficient in energy. He also expressed the view that because Congress reversed the action of the court, everyone must suffer the delay caused by the litigation and that he would not agree to compensate "those who sought to further aggravate the injury." This would in his view be subsidizing lawyers to bring suits against our national interests. Finally, he argued that Alyeska should not be liable for the "sins of the Government," and thus fees should not be awarded against any party.

Another judge filed a separate dissenting opinion in which the other two dissenters joined. This opinion contended that delaying for several years the delivery of oil from the North Slope conferred no public benefit on the United States. The dissenters saw plaintiffs' net achievement as an amendment of the Mineral Leasing Act to authorize wider pipeline rights-of-way; against this benefit they argued "must be weighed the public *dis*service in blocking access to the much needed oil at a critical time in our history, and the enormously higher costs we must all pay." The minority concluded that an award of attorneys' fees would deviate from the requirements of the private attorney general rule that plaintiffs (1) prevail on some important legal issue and (2) confer a public benefit, and they said that awarding fees to these plaintiffs would encourage much more ill-founded litigation.

The United States Supreme Court granted Alyeska's petition for review of the decision on October 15, 1974, and on January 22, 1975, the case was argued before the Court. The Court's decision should have great significance in the field of public interest litigation.

Observations

It is not our function to express a judgment on the merits of the TAPS case. We should, however, offer some observations concerning the role of the public interest lawyers.

Those having an immediate financial interest in the trans-Alaska pipeline project, principally the oil companies, had direct access to the administrative agencies, the courts, and the Congress and the economic wherewithal to present their view on all aspects of the project. Individually, environmentalists and environmental organizations lacked the resources to marshal their evidence and present it to the decision makers. As a result, access to the decision makers was certainly something less than equal as among those holding differing views. Such imbalance in advocacy creates a real risk that the final decision will be biased in favor of the better-represented interests.

Public interest lawyers see their role in such cases as that of advocates for the legitimate points of view which would otherwise be unrepresented, or at least underrepresented, in the decision-making process. They do not contend that they have the omniscience to know wherein lies "the public interest" and to be speaking as the exclusive advocates of such interest. Rather they contend that large groups of individuals and organizations have interests and concerns which should be ably represented in truly adversary proceedings so that the final policy decisions will be based on a consideration of a balanced presentation of all relevant points of view. The public interest lawyer is, quite simply, a legal advocate for special interests that would otherwise be without such an advocate.

In the TAPS case the public interest lawyers' representation of environmentalists led to major substantive changes in the trans-Alaska pipeline project and forced the Congress to make the ultimate decisions. Regardless of whether one likes or dislikes the impact public interest lawyers had in the TAPS case, he cannot dispute the right of the environmentalists to have their voices heard and their views considered by the decision makers whose action carries such widespread consequences.

Examination of Public Interest Litigation

Public interest litigation is conducted by basically three types of tax-exempt organizations: (1) law firms, in the sense of corporate entities qualified under state law to engage in the practice of law and which may or may not have large public memberships, (2) non-licensed corporations staffed exclusively or primarily by lawyers, and (3) non-licensed corporations primarily or substantially oriented to scientific, educational, or other exempt activities with staff attorneys employed to engage in litigation where necessary to carry out the basic purposes of the organization. Within any particular category, the methods of operation may vary among organizations; in the second category, for example, some rely exclusively on staff lawyers to handle their cases while others employ private counsel for particular cases and use staff lawyers in a supporting role. Ad hoc local groups formed to deal with specific local issues have been significant in some of the earliest cases, but today their role seems to be basically that of clients, not themselves tax-exempt litigators. The considerations relevant to each of the three main types of organizations are essentially the same. Where differences are significant as among the types they are noted in the following discussion.

Public interest litigation takes many different forms and involves myriads of issues. Environmental litigation was one of the first types to reach significant proportions and today continues to be a major portion of public interest legal activity. Examples of environmental litigation include the following:

- Suits against the EPA. These may involve challenges to air or water quality standards or the enforcement of deadlines under statutes requiring agency action.
- Suits against other federal agencies. These cover a wide range of subjects such as the need for or adequacy of environmental impact statements, the issuance of federal permits and licenses, the registration of pesticides and other chemicals, and so forth.
- Participation in administrative proceedings to set air or water quality standards and in subsequent appeals from initial administrative determinations.
- Suits to enforce standards regulating air or water quality under statutory provisions authorizing private enforcement in the event of governmental inaction.
- Highway and rapid transit cases which can involve issues of air pollution, conservation, relocation housing, rights of the poor, and many other considerations.
- Public utility litigation involving the need for and siting of power plants, the public safety of nuclear power, air pollution and waste disposal, and utility rate structures.
- Other land use issues such as "inverse condemnation" (for example, the effect of noise and use of air space on property owners surrounding a newly approved public airport) and "down zoning" (for example, the imposition of environmental zoning restrictions limiting the economic development of land).

In general, many public interest lawyers assert that their primary task is to force administrative agencies and private enterprises to hew to the letter of the law – if the law proves to be too severe in terms of economic or other consequences, the political process will then take over to balance the conflicting considerations and rewrite the law. On the other hand, the effect of such litigation may be to curb an agency's right to use its prosecutorial discretion to avoid enforcement of the law in cases which offend common sense or to respond intelligently to changed conditions or circumstances not anticipated by the legislature.

It has often been contended that regulatory agencies tend to be co-opted by the regulated and that most administrative agencies tend to acquire and serve their own constituencies and vested interests. As a result of the foregoing, real conflicts among agencies are not infrequent (the EPA versus TVA on matters involving coal burning power plants, to cite one example). Public interest law groups bring a new dimension to administrative proceedings. Court proceedings often force agency recognition of broader horizons, as well as flushing out new areas requiring attention.

As the attorneys' fee portion of the TAPS case illustrates, however, it is possible for 7 judges of one court to split 4 to 3 into diametrically opposed camps on the basic question of what litigation is truly in the "public interest."

The Problem of Identifying Charitable Litigation

Under the Constitution of the United States the function of the judiciary is to decide real "cases and controversies" between real people. Generally speaking, the courts do not render advisory opinions or determine rules of law on the basis of hypothetical facts. Litigation between adversaries is a method for resolving disputes and is not an activity which by itself can be classified as charitable.

On the other hand, litigation seems clearly proper as a means to achieve a proper charitable goal. To our knowledge this proposition is not challenged today. The IRS has for years recognized the propriety of a tax-exempt organization's legal representation of members of minority groups. As noted in the introduction to this report, the regulations expressly provide that section 501(c)(3) encompasses an organization whose purpose is "to defend human and civil rights secured by law."[63] Also, as noted in Chapter II, certain recent federal pollution control statutes authorize citizen suits as a means of enforcing compliance with the substantive requirements of the statutes, and such statutes evidence a public policy favoring the judicial resolution of issues involving conflicting interests. In short, litigation is the peaceful means for resolving disputes and vindicating protected rights in a governmental system based upon the rule of law. In fact, the United States Supreme Court has said that litigation, and the organized support of litigation, to advance lawful ends are "modes of expression and association protected by the First and Fourteenth Amendments."[64]

There are, however, potential abuses against which the tax laws must guard. A tax-exempt organization must not litigate on behalf of self-sufficient private interests, for to do so would violate the prohibition against the private inurement of the organization's earnings as well as the basic requirement that the organization must serve a public, not a private, purpose. Further, it would not be a charitable activity for an organization to seek to achieve its charitable goals through a program of harassing law suits which are not soundly based legally or factually and which produce great hindrance to the defendants; nor would it be charity for an organization to engage in litigation for the purpose of advancing the private interests of its contributors, directors, or employees.

The problem, then, is to find the standard or test that identifies charitable litigation and delineates it from non-charitable litigation.

The Primary Policy Issue

The principle that litigation is a proper means to achieve a charitable end has usually been applied to cases in which the tax-exempt organization has been seeking to protect the interests of persons who come within the classes of traditional objects of charity (for example, the poor and distressed, the underprivileged and members of disadvantaged minorities). In such cases, a direct grant of money, food or clothing would be a charitable activity and the furnishing of legal services and representation would be no less charitable. Such litigation activity is charitable even when the purpose thereof is to secure a direct economic benefit for the person being represented.

Public interest litigation extends the benefits of tax exemption to persons not within the classes of traditional objects of charity. Consequently, the primary policy question to which we recommend the Filer Commission address itself is, What are the appropriate standards for determining the boundaries of tax-exempt charity which furnishes legal representation to persons who do not themselves qualify as objects of charity under traditional standards? To answer this question the focus must be more on the role played by the organization in its representation of such persons than on the status of the recipients of the benefits.

The policy question can best be resolved by analyzing specific criteria and rules which may be developed and employed to delineate the boundaries of tax-exempt litigating activities. "Public interest litigation" is the usual label assigned to those litigating activities found to qualify as charity, and the balance of this discussion focuses on certain criteria and rules that have been or may be utilized to identify public interest litigation and the subsidiary policy issues encountered in the formulation of such criteria and rules.

Criteria and Rules for Identifying Public Interest Litigation

The IRS Guidelines. The current position of the IRS is reflected in Rev. Proc. 71-39, 1971-2 C.B. 575, the text of which was first published in a news release on November 12, 1970. This publication will hereinafter be referred to as the "IRS Guidelines." Before considering the substance of the IRS Guidelines it is enlightening to recount briefly the history of their formulation and publication.

Public interest law groups were a phenomenon of the late 1960s. Prior to 1970 the IRS issued several determination letters to organizations engaging in public interest litigation holding that they qualified as tax-exempt charitable organizations. As new organizations were formed and additional applications for exemption were submitted, the IRS determined in early 1970 to undertake a study of the whole subject of public interest litigation before issuing any additional determination letters. The study ran through the summer months of 1970 with a result that one or more newly formed organizations were left without an IRS approval of litigation activities. On September 30, 1970, the Honorable Russell E. Train, chairman of the President's Council on Environmental Quality, submitted to the IRS a legal memorandum in support of tax exemption and expressed the view:

> Private litigation before courts and administrative agencies has been and will continue to be an important environmental protection technique supplementing and reinforcing government environmental protection programs.

On October 9, 1970, the IRS issued a news release announcing the study and the temporary suspension of rulings on the tax-exempt status of public interest law firms, stating that the study should be completed within 60 days and expressing the view that it was then unable to make any judgment about the deductibility of contributions made during the period of the study. As later explained by Commissioner of Internal Revenue, Randolph W. Thrower, the announcement was made to get the study "off dead center" and to obtain the benefit of wide participation. The announcement, however, brought a storm of protest from many members of Congress, administration officials, practicing lawyers and law professors, public interest groups, news media, and others – much of it sincere and some of it political and one-sided in content, but a real storm nevertheless. Less than a week later the IRS issued a second release explaining that donors to public interest law firms would be fully protected in making contributions to such firms holding previously issued favorable rulings.

Almost immediately, Senator Nelson, chairman of the Senate Subcommittee on Employment, Manpower and Poverty, which was then in the midst of public hearings on the program of legal services for the poor, announced that his subcommittee would hold hearings in mid-November and requested Commissioner Thrower to appear as the lead-off witness. The Senate Committee on Interior and Insular Affairs, chaired by Senator Jackson, soon published a report containing "Selected Materials on Tax Exempt Status and Public Interest Litigation." As noted above, the IRS completed its study and issued its Guidelines on November 12, 1970. Senator Nelson's subcommittee held hearings on November 16 and 17, compiling quite a large record. With the issuance of the IRS Guidelines and the Commissioner's explanation of their substance and the reasons for their formulation, most witnesses expressed their general satisfaction with the Guidelines. While the storm soon subsided, there was lingering dissatisfaction with the manner in which the subject had been handled.

The IRS Guidelines apply generally to "organizations formed to provide legal representation in the public interest." The approach of the Guidelines is to differentiate between organizations representing the interests of "a majority of the public" and those representing "a disadvantaged minority, the victims of racial discrimination, or those denied human and civil rights," all of whom have traditionally been recognized as proper objects of charity. The eight guidelines apply to the first category of organizations and may be summarized as follows:

1. The organization's role in litigation can reasonably be said to be in representation of "a broad public interest rather than a private interest." Normally it would not extend to direct representation of litigants in actions between private persons "where their financial interests at stake would warrant representation from private legal sources."

2. The organization does not accept fees for its service, except in accordance with procedures approved by the IRS.

3. The organization does not engage in a program of disruption of the judicial system, illegal activity, or violation of canons of ethics.

4. The organization files with its annual tax return a description of its cases and the rationale for their public benefit.

5. The policies and programs of the organization are determined by a board or committee "representative of the public interest" and which is not controlled by the litigating staff or any noncharitable organization.

6. The organization does not operate, such as by sharing office space, in a manner so as to create identification or confusion with a private law firm.

7. There is no direct or indirect arrangement to provide a tax deduction for the cost of litigation "which is for the private benefit of the donor."

8. The organization otherwise complies with section 501(c) (3), specifically not participating in political campaigns, not permitting inurement of its earnings to a private shareholder or individual, and not engaging in any substantial lobbying activities.

While the IRS indicated at the time of promulgation of the Guidelines that there would be a study and revision of the section 501(c) (3) regulations to incorporate standards relating to litigation, with the usual procedure of public notice and hearing, to date no revision of the regulations has been publicly proposed.

After more than four years of experience with the IRS Guidelines there appears to be a general consensus among the many public interest lawyers interviewed by us that the Guidelines are generally adequate with respect to the determination of tax exemption for public interest litigating activities. They do not, however, explain very clearly what is encompassed within "public interest" litigation. Furthermore, the IRS Guidelines mingle indispensable tax rules with policy determinations and administrative matters. We have therefore attempted in Chapter V of this report to reorganize and set forth in semi-technical language a set of criteria and rules for determining tax-exempt public interest litigation. These criteria and rules provide the points of reference for the balance of our discussion of the policy issues considered herein.

"Public interest" defined. There is essentially unanimous agreement among public interest lawyers that they do not purport to represent *the* "public interest" — indeed, no single interest can be "the public interest" because the interests of the individuals and entities comprising the public in a pluralistic society are diverse and in numerous ways conflicting. It is therefore possible for two or more groups of public interest lawyers to be arguing for different results. For example, a case involving the construction of a dam may involve persons variously interested in (1) preserving the existing scenery and water and land uses, (2) developing a new source of hydro-electric power, (3) providing flood control, and (4) making new uses of the water and land resources – and each such interest could be labeled "a public interest."

We find, therefore, that an organization cannot properly be said to be *representing* the public interest in the cases it undertakes. However, the representation of special interests, whose voices might otherwise go unheard, advances the public interest because, under our system of government, the rights and liberties of all lawful interests are entitled to the equal protection of the law and such protection is of special concern when a contested matter is up for decision by a court or an agency. We conclude that the advancement of these fundamental concepts of our Constitution is what supplies the "public interest" in public interest litigation.

Proposed criteria and rules. As just noted, the role of public interest lawyers is functionally the same as that of private lawyers – the representation of their clients' special interests. Something more, of course, is needed to qualify a litigating organization as a tax-exempt charity. In the following chapter we suggest three basic criteria for use in determining whether an organization's legal representation of clients qualifies as public interest litigation. We have also outlined a series of rules for (1) applying the criteria to particular cases, (2) relating to the organizational structure of a public interest law group, (3) governing the operations of an organization to adhere to the limitations of section 501(c) (3), and (4) providing for the collection of attorneys' fees.

The three basic criteria have been distilled from the IRS Guidelines and our interviews with public interest lawyers and others, and we believe that the criteria would meet with general agreement among public interest lawyers. They also serve to explain the rationale for extending tax exemption to the representation of certain persons who do not qualify for the receipt of charity. The four categories of rules would probably not meet with the same general agreement. Some of the rules are fundamental requirements of present law and some represent policy matters on which judgments must be made and on which there can be wide differences of opinion. In the following discussion we have attempted to reflect all points of view expressed to us.

The three critiera may be summarized as follows:

> One, the interests of an organization's clients are otherwise unrepresented, or at least underrepresented.
>
> Two, the clients lack the financial resources to employ private counsel, or the cost of private counsel is out of proportion to the economic interests at stake.
>
> Three, the litigation has significance for a substantial segment of the public.

Some public interest lawyers regard a combination of the first two as sufficient. The point has been made that much environmental litigation, as well as certain other classes of cases, may involve costs of hundreds of thousands of dollars for expert witness fees, research, court costs, and so forth, and even a substantial group of affected persons with incomes well above any assumed poverty level may be unable (or unwilling because of the amount at stake) to finance the presentation of their views in such litigation. Is it sufficient in such cases to say that only the first two criteria need be satisfied?

In answer to this question it has been argued that tax-exempt hospitals provide health care to persons of all economic levels, that legal care has become as important in our society as health care and that legal care institutions should be accorded the same tax status. As set forth in the appended footnote,[65] the Congress has recently made a finding as to the great importance of adequate legal assistance for those unable to afford private counsel. Even assuming health and legal care are of nearly equal importance, it is difficult analytically to analogize legal care to hospital care. Hospitals, in addition to providing emergency care, provide physical facilities at which physicians can render medical services. There is no direct parallel in the field of legal care – while the lawyer's role is similar to that of a physican (and both are taxpayers), the courts, which are most closely analogous to hospitals as institutions, are provided by government, not private nonprofit entities, and most of the costs of the court facilities and staff are paid from governmental revenues.

It is true, however, that access to the courts in certain types of cases (usually those involving or affecting substantial segments of the public) requires the expenditure of large sums of money to employ experts and/or to assemble and analyze voluminous scientific or other data. In such cases, the charges levied by the court may be modest but the cost of proceeding in the court may be as expensive as, or more expensive than, the cost of providing long-term hospital care. In these instances there is a similarity between a hospital as a health care institution and a public interest law group (which would bear the litigation costs) as a legal care institution.

Notwithstanding the foregoing, it does not appear that an analogy to hospitals necessarily compels the conclusion that criteria one and two by themselves are sufficient to support tax exemption for public interest law groups. Protecting the health or life of one individual is itself a benefit to a society in which each individual is important, and the full public benefit of a hospital lies in the fact that it is operated to provide such protection, within its capabilities, to all individuals. Providing legal representation to an individual, or a small group of individuals, in a case having no particular significance to any others, does not appear to confer the same degree of public benefit.

If, however, the legal welfare of an individual were to be considered as important as his health and life, then the ability to pay referred to in criterion two would lose much of its significance in developing a policy for ensuring such welfare. But where a private economic interest is substantial enough to warrant employment of private counsel and the client has sufficient funds to do so, direct representation of the client's interest by a tax-exempt organization is precluded by the IRS Guidelines – we think properly so, for it is difficult to perceive how such representation confers any public benefit that would not otherwise come to pass without the participation of a tax-exempt entity. Most public interest lawyers appear to agree that their participation (if any) in such litigation should be in a role other than the direct representation of such private interests.

It follows from the foregoing that, as important as individual legal care is, both criteria one and two are essential elements in a finding of public benefit. By themselves, the two criteria could apply to cases in which the resulting public benefit would be very slight. Where, however, the private interests involved in a case and the clients' financial resources are, individually and collectively, relatively small when compared to the cost of the litigation, the significance of the case to a modest number of other persons greatly increases the magnitude of the public benefit.

To illustrate the last point we would refer to an example, considered by the Commissioner of Internal Revenue in his testimony before Senator Nelson's subcommittee,[66] of litigation involving a small private lake with six private land owners, against one of whom the other five were complaining about pollution of the lake. Commissioner Thrower opined that representation by a tax-exempt organization of the five complainants would not normally be within the IRS Guidelines. He indicated, however, that moving the setting to the shores of Lake Michigan or to the bank of a significant river, or adding the ingredient of a public beach or camping ground also sharing the lake, would seem to bring representation by a tax-exempt organization within the Guidelines.

It appears to us that, if tax exemption is to be accorded to public interest law groups representing persons who do not qualify for charity, criterion three is necessary to provide a degree of public benefit sufficient to merit tax-exempt status. The three basic criteria, taken together, are consistent with the policy of the IRS Guidelines and the views expressed to us by public interest lawyers. We believe, therefore, that they provide the building blocks for constructing a workable test for identifying tax-exempt litigating activities.

We turn next to a consideration of the public significance referred to in criterion three. The IRS made clear when the Guidelines were published in 1970 that it was not going to be the judge of whether a particular case (that is, the result sought in litigation) was or was not in the public interest. In the IRS view, it is the furnishing of legal representation, not the cause, that generates the public benefit. To cast the tax collector in the role of arbiter of the public good would require the Service to make many subjective ad hoc decisions, some of which could involve controversial or unpopular causes. Some believe that the IRS is subject to too many political pressures to assume this role, but whether that be true or not the proper administration of the tax exemption provisions of the Internal Revenue Code does not require the IRS to go so far. It follows, therefore, that public interest litigation should not for tax purposes be defined in terms of causes or classes of litigation, even if it were possible (as seems unlikely) to develop detailed rules defining each permissible category of public interest litigation and to anticipate all of the variations that may arise in the future. It is for this reason that we have concluded that environmental litigation cannot appropriately be considered as a separate topic but must be treated as a component of the broader topic of public interest litigation.

Because public interest litigation cannot be defined in terms of causes or classes of litigation, criterion three is drawn in terms of the significance of a particular case to persons not directly involved in the case. The significance might be the physical subject matter of the case (an important natural resource or a pesticide, for example), the construction of a statute having broad application, or the enjoining of governmental or private conduct that violates statutory law and affects a significant number of people.

As explained in Chapter V in the rules for "Application of the Criteria," the determination of when an organization's representation of clients is in the public interest depends upon a balancing of the three criteria. Thus, the smaller the number of clients, the greater should be the public significance described in criterion three. Similarly, the clients' economic interests should normally, particularly in suits against private parties, be comparatively small and the public significance should be substantial.

At this point we should note the effect of a structural difference between nonmembership public interest "law firms" and large membership organizations engaging in litigation. The difference affects their functional role in litigation as determined by the rules of the federal courts with respect to who has "standing to sue." An organization has the right to sue (in its own name as the plaintiff) in a federal court action against a federal agency if it can show that, by reason of agency action, it has suffered some "injury in fact."[67] The injury need *not* be economic but may be aesthetic, conservational, or recreational. The organization *lacks* standing to sue if it seeks merely to act as a "representative of the public," even if its usual charitable activities give it a special interest in the outcome of the case.[68] The requirement of "injury in fact" is usually easily satisfied by a showing that one or more bona fide members of the organization are in some way individually affected – for example, they camp or hike on land involved in the suit, they personally have suffered or will suffer from pollution at issue in the suit, or they have some other similar interest in the outcome. Many public interest lawyers believe that the membership of the affected individuals must be bona fide in the sense that they financially support the organization, such as by paying customary membership dues. It also appears that, as a procedural matter, the organization must establish that the injured members have requested the organization to represent their interests.[69]

Organizations with large, geographically dispersed memberships are therefore in a position to engage in litigation in their own name and to be represented by their own salaried staff lawyers. The injury to one or more members (the nominal "clients") needed to satisfy the "standing to sue" requirements is usually so small that it should raise no problem under the IRS Guidelines or the basic criteria described herein, especially where the suit has significance to many persons other than members.

A non-membership public interest law firm is not in a position to sue in its own name (unless, by chance, one of its lawyers happens to meet the standing requirements), and thus is solely in the position of acting as counsel for clients who meet the standing requirements. The standing test in these cases is going to be applied, not to the law firm itself, but to the clients represented by the public interest lawyers. The client might be a large membership organization with standing to sue (as was true in the TAPS case), but more often the cases involve individuals or ad hoc groups of individuals with direct interest in the litigation. It is in the context of this type of representation that the need for criteria and rules to distinguish public interest litigation from private interest litigation is greatest.

Aside from the issue of legal fees discussed at length below, there appears to be general satisfaction with the IRS Guidelines (and we think, therefore, with the three basic criteria proposed herein) as to the determination of which public interest litigating organizations come within the charitable definition.

Who is to select public interest litigation? The IRS Guidelines provide that an organization's legal representation may be on "any subject of public interest as determined by the applicant [the organization]." Guideline 5 provides that the policies and programs of the organization are to be the responsibility of a board or committee representative of the public interest. These rules are consistent with the position that the IRS will not be and should not be the judge of causes or the arbiter of the public good. Those interviewed by us uniformly agreed that public interest law organizations should select their own litigation and that ultimately the courts are in the best position to determine what legal action is in the public interest (and the corollary, what legal action is harassing, vexacious, disruptive, or frivolous).

The fact that all concerned agree that the tax-exempt organizations are to select the public interest litigation does not necessarily mean that there are no tax policy issues requiring at least some discussion. A very basic policy consideration arises from the fact that an organization's sources of support will in some degree affect the character of its litigation activities. Thus, the organization's results must satisfy contributors for the contributions to continue. Grantor foundations may impose standards or restrictions on the use of grants. The ability to collect legal fees, from private clients or from court awards against opposing parties, provides an economic incentive for an organization to undertake litigation productive of such fees.

While an organization's sources of support will have some effect on its operations, this is typical, rather than unusual, in the charitable field. From the family or company created private foundation to the public charity dependent on annual fund-raising drives, charitable organizations are influenced by their contributors. This principle is one of the foundations for private philanthropy in our pluralistic society and is even utilized to grant certain charities a preferred status under the tax laws. Thus, contributions to certain organizations are deductible to the extent of 50 percent of an individual's income, while contributions to other organizations are restricted to a 20 percent limit.[70] The preferred organizations include churches, schools, hospitals, and "publicly supported organizations." Generally speaking, the last type is an organization that annually receives one third of its total support in the form of a significant number of relatively small contributions.[71] The rationale for granting this preferred status is that the receipt of such public support indicates the organization is responsive to public needs, for should it cease to be so responsive the public support would then dwindle.

The IRS Guidelines are generally silent on the subject of an organization's support (other than the rule relating to legal fees) but do contain two principles relevant to the matter of the selection of public interest litigation: the principle relating to private control and the principle relating to illegal conduct.

Guidelines 5 and 6 provide in substance that an organization is not to be controlled by, or to be confused with, any private noncharitable interest or law firm and the litigating staff attorneys are not to control the organization's litigating policy. Section 501(c) (3) requires that tax-exempt charities be operated "exclusively" for charitable purposes. The IRS therefore has a legitimate reason – indeed a duty – to satisfy itself that each organization is operating for charitable, not private, purposes. Clearly, an organization should not be permitted to use its tax exemption as a facade behind which it carries on a profitable enterprise or acts as a litigating arm on behalf of a profitable enterprise capable of securing private legal representation; such operations would not satisfy the exclusively charitable test of the tax law.

To insure compliance the Guidelines call for managerial policy to be vested in a board "representative of the public interest" and they bar control by any noncharitable organization or group or by the litigating staff. These requirements and restrictions are somewhat unusual in the charitable field. A foundation or other charity is often controlled by the family or corporation which created it, and such control normally has not affected tax-exempt status so long as the organization's operations were exclusively charitable. Similarly, a distinction between an organization's governing board and its staff is not often relevant for tax purposes. In the case of litigation, however, particularly litigation which can have substantial impacts on private interests, the need for assurances that an organization will serve exclusively charitable purposes is perhaps greater than in the more traditional fields of charity. Furthermore, any rules intended to provide such assurances must be administratively workable and to the extent feasible must keep the IRS out of the role of having to weigh the merits of individual cases.

The administrative problems of the IRS should not be underestimated. With respect to most charitable organizations, the participants and the IRS have a reasonably clear idea of what the organization will do and how it will do it, and the charitable purposes and public benefits are reasonably well-defined. But, when public interest law groups first appeared (about 1969), the IRS was faced with several problems: (1) there were no traditional organizational molds or methods of operation to provide precedents, (2) the organizations proposed acting on behalf of persons who were not usual objects of charity, (3) the organizations' activities could extend into nearly every aspect of human life and endeavor, and (4) the IRS recognized that it and its field agents should not be responsible for judging charitable operations on a case-by-case basis.

To solve the problems, the IRS chose to place operational responsibility on a managerial board "representative of the public interest." Literally, compliance with the requirement is impossible because no individual can legitimately claim that he has flawlessly identified the public interest and is the representative thereof. Practically speaking, however, the requirement is satisfied by having a board composed of members who are drawn from several segments of the community and who possess some experience relevant to the judgments to be made by the board. By shifting managerial control from the staff or particular private interests to such a board, the IRS has obtained some assurance of exclusively charitable operations and the public interest law organizations have obtained some insulation from subjective judgments by examining agents.

One further point should be made concerning Guideline 6 which prohibits identification with any particular private law firm or practice. It has been suggested that the development of organizations with mixed practices (but with careful financial segregation for the tax-exempt portion) would further the goal of adequate legal representation for all. Here, again, the principal problems are administrative, not legal. The tax law precludes inurement to private persons of the earnings of a tax-exempt organization. If an entity is divided into two departments, one tax-exempt and the other taxable, the IRS must be concerned that (1) cases are not selected for the charitable department to indirectly benefit the taxable department, (2) private inurement does not result directly from sharing of staff and facilities, and (3) solicitation and promotional advertising of the charitable activities is not used to benefit the profit-making activities. These concerns, especially from the viewpoint of the tax collector, are real, but perhaps the ingenuity of the public interest lawyers will help them find satisfactory solutions. We, frankly, cannot.

In any event very little criticism of Guidelines 5 and 6 has been expressed to us; such criticism as we have heard has been expressed in terms of an inhibiting effect on experimentation with new forms. The Guidelines provide, however, that they "are not inflexible" and that any organization will be afforded an opportunity to show that adherence to the Guidelines is not required in its particular case to ensure that its operations are exclusively charitable. Consequently, we have incorporated in the "organizational rules" set forth in Chapter V the requirement for a "public" board to determine an organization's policies and programs and otherwise have attempted to impose no restriction (other than restrictions compelled by present tax law) on organizational form.

The second principle bearing on the selection of public interest litigation is Guideline 3 which provides that an organization must not attempt to achieve its objectives "through a program of disruption of the judicial system, illegal activity, or violation of applicable canons of ethics." It has been argued that the IRS should have no more interest in the professional ethics and conduct of a public interest law organization than it does in the ethics and conduct of a taxpaying law firm. In other words, the IRS should not attempt to be the enforcer of ethical standards.

Commissioner Thrower, in his testimony before Senator Nelson's subcommittee, indicated his agreement with this view. The key word in the Guideline is "program" – a regular program of unethical or illegal conduct would be inconsistent with exclusively charitable operations and would be grounds for revocation of tax exemption. Isolated instances of excesses by a particular individual would not seem to raise any issue of failure to adhere to the Guideline or the tax law. The "operational rules" stated in Chapter V include this principle and make clear that a "program" of improper conduct means a "regular course of conduct."

In summary, there appears to be general satisfaction with (1) the principle that the selection of public interest litigation is to be the function of the public interest law organizations, subject to the control of the courts and the bar, and (2) the Guidelines which are intended to ensure that the litigation selected serves exclusively charitable purposes. The only major unresolved policy issue bearing on the selection of cases is the issue relating to the collection of legal fees, and this topic is discussed at length below.

Relief to be sought. Most public interest cases seek injunctive relief. Injunctive relief against a governmental agency may be to restrain specific action (the issuance of the permits in the TAPS case, for example) or to influence or overturn policy decisions (regulations promulgated by an agency under a statute delegating policy-making authority to it, for example). Injunctive relief against private parties relates to specific actions, such as failure to comply with pollution control laws.

Some cases, however, may involve a claim for monetary damages. We have not been advised of any instance in which a tax-exempt organization has sought damages for itself, and it is difficult to imagine a case where anything more than nominal damages would be appropriate (other than in nonpublic interest litigation where the organization is seeking as a private party to redress a wrong committed against it – for example, damages for wrongful destruction of its property).

When damages are sought on behalf of clients, a question may arise whether the public interest organization is engaging in an exclusively charitable undertaking or is representing a private economic interest. It appears, however, that this is not a tax policy question distinct from the larger question of identifying public interest litigation. Expressed differently, the relief sought in a particular case is one factor to be considered in determining whether the legal representation is a charitable activity, the determination to be made under the criteria analyzed above. In a suit on behalf of one or more persons of limited financial resources and involving a statutory construction issue of wide public significance, a claim for monetary damages would be appropriate under the test for public interest litigation described herein.

In Chapter V, the rules for "application of the criteria" and the "operational rules" have been drafted to provide, with respect to relief to be sought in public interest litigation, for the widest possible latitude consistent with the minimum requirements of the tax law. Finally, we have not uncovered any separate unresolved tax policy issue with respect to the matter of judicial relief.

Collection of Attorneys' Fees

The issue of permitting the collection of attorneys' fees is extremely complex in nature and difficult of solution. The issue is also of extreme economic importance to many public interest law organizations who have been advised by foundations that, having provided the seed money to found the organizations for an initial period, the foundations plan to curtail future funding. IRS Guideline 2 provides that a public interest law organization shall not accept fees for its service except in accordance with procedures approved by the IRS. Numerous requests for rulings have been submitted to the IRS, but it was not until early October 1974 that any private rulings were issued. Public rulings were not published until February 19, 1975, when the IRS released the text of Revenue Rulings 75-74, 75-75 and 75-76 and Revenue Procedure 75-13. The following discussion attempts to analyze the many factors and views that must be considered and to expose the primary policy matters on which judgments must be made.

Fundamental considerations. This segment of our report sets forth in general terms some fundamental considerations relevant to one or more aspects of the legal fees issue. Following segments deal with specific situations in the light of these considerations.

First is the matter of two principles applicable to the operation of any section 501(c) (3) organization:

1. One of the basic principles of section 501(c) (3) is that no part of the net earnings of the organization shall inure to the benefit of any private shareholder or individual.

2. A second fundamental principle applicable to most charitable organizations, but with varying degrees of effect, is that tax exemption should not confer a competitive advantage to an organization engaging in a business activity which is also engaged in by taxpaying individuals and entities. This latter principle is implemented through a tax on an exempt organization's income from an "unrelated trade or business." Such a trade or business is defined by section 513 to mean any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501(c) (3). Violation of the prohibition against private inurement of earnings is a ground for revocation of tax-exempt status. On the other hand, engaging in an unrelated business activity normally results only in the imposition of tax on the net income from the activity, and not total loss of tax-exempt status, unless the activity is so substantial that the organization in question is not in fact being operated for exclusively charitable purposes.

As will be seen, the foregoing principles, together with the criteria for identifying public interest litigation, provide the framework within which the issue of the collection of attorneys' fees must be resolved.

It seems clear to us that the attorneys employed by a public interest law organization must not receive their compensation in the form of a percentage of the fees collected by the organization (as is traditional in law partnerships). Such compensatory arrangements would raise serious questions about private inurement of the organization's earnings. As explained by the IRS in Rev. Rul. 69-383, 1969-2 C.B. 113:

> Under certain circumstances, the use of a method of compensation based upon a percengage of the income of an exempt organization can constitute inurement of net earnings to private individuals. For example, the presence of a percentage compensation agreement will destroy the organization's exemption under section 501 (c) (3) of the Code where such arrangement transforms the principal activity of the organization into a joint venture betweeen it and a group of physicians (*Lorain Avenue Clinic* v. *Commissioner*, 31 T.C. 141 (1958)), or is merely a device for distributing profits to persons in control (*Birmingham Business College* v. *Commissioner*, 276 F.2d 476 (1960)).

In that ruling the IRS approved an agreement under which a hospital would pay a radiologist a fixed percentage of the gross billings of the radiology department; the payments were made as compensation to the radiologist for managing the department, participating in the hospital's educational program, and performing all radiological services required by the hospital. Because (1) the radiologist had no management authority with respect to the hospital, (2) the hospital (with approval of the radiologist) established the amounts charged for services rendered and handled the billing and collecting of charges, and (3) the compensation was not excessive, the IRS held that the agreement did not violate the private inurement prohibition.

The legal staff of a public interest law organization is distinguishable from the radiologist considered in the foregoing ruling. The radiologist was a single individual employed to manage a department whereas the legal staff has no similar managerial and departmental structure. More importantly, the need for radiological services is determined solely by the requirements of patient care whereas the availability of attorneys' fees is determined largely by the types of cases undertaken by the public interest law organization. This element of selectivity means that no advance judgment can be made as to the reasonableness of any percentage compensation arrangement.

We conclude, therefore, that the private inurement rule requires that the compensation of employee-attorneys must be based on fixed salaries or some other standard unrelated to the legal fees collected by the employer-charity.

The TAPS case raises a variation of the private inurement problem. It will be recalled that the court of appeals directed that the fees awarded in that case are to be paid to the individual attorneys, not their employer-charity (although the attorneys have represented to the Supreme Court that they have agreed to pay the fees over to their employer). Where there is no pay-over agreement with the employer, it may be suggested that the individuals are taxpayers so that the employer's tax exemption will not shelter the fees. On the other hand, the individuals are subsidized by a salary paid from the tax-exempt funds of the employer. Furthermore, the fees are payable for services rendered within the scope of the attorneys' employment and would therefore normally be thought to belong to the employer. A direct court award of fees to the employer may, however, raise questions about the unauthorized practice of law if the employing entity is not itself licensed to practice law. While the questions of ownership of the fees and authorization to practice law are not matters for decision under the tax law, the tax rule with respect to legal fees must be drawn with these matters in mind. In the "operational rules" contained in the discussion draft in Chapter V, we have concluded that an attorney-employee cannot retain a direct award of fees for services rendered within the scope of his employment and that such fees are to be regarded as the earnings of the employer.

If legal fees are to be collectable from clients of a public interest law organization, the question of the effect of tax exemption on competition with private taxpaying lawyers comes into play. Tax exemption for fees collected by a public interest law organization could be the basis for "price-cutting" vis-a-vis taxpaying lawyers (but, on the other hand, the legality of minimum fee schedules is today subject to serious challenge). The question of competition goes beyond the usual unrelated business income inquiry – it leads back to the basic question of which litigation is in the public interest. If a client has the financial resources to employ private counsel, representation of that client (much less the collection of a fee) would fail the public interest litigation criteria described earlier in this report. The hardest question is posed when the clients have the ability to make a small payment which would be insufficient to obtain competent private representation. In such cases the legal representation may pass the public interest litigation criteria and therefore be clearly related to the organization's tax-exempt purpose. This consideration is further analyzed below in the discussion of the sources from which legal fees could be collected.

The collection of legal fees could make a public interest law organization self-supporting. The receipt of substantial fees could even make tax exemption unnecessary, except to the extent of an organization's desire to avoid the income tax expense. There are, in fact, in existence today non-exempt law firms formed for the purpose of engaging in public interest litigation and collecting fees when possible and appropriate – and, of course, paying income taxes on their net earnings. Some public interest lawyers believe, however, that tax exemption is an important ingredient for their credibility in court as an organization acting to advance the public interest. If tax exemption is maintained and fees become the sole source of support, the factor of public responsiveness (arising from the continuing need for public contributions) is lost. Moreover, an organization supported solely by fees would, out of economic necessity, have to consider the availability of fees in the selection of at least some of its cases, and at that point the only feature distinguishing it from the profit-making taxable public interest firms would be the compensation arrangements for the attorneys.

Certain recent statutes (such as the Clean Air Act Amendments of 1970) authorize suits by private citizens and provide for the awarding of costs, including attorneys' fees, to a successful citizen plaintiff. The rationale of such provisions is that they will encourage enforcement of, and adherence to, the substantive provisions of the law. Even in the absence of such statutes the courts, as illustrated by the TAPS case, have developed a rule for awarding fees to a party who has acted in effect as a "private attorney general" in accomplishing some significant public benefit. It has been argued that the statutory or judicial policy approving the award of fees should be sufficient grounds to justify the receipt of legal fees for a public interest law group whose action qualified it for such fees; it is contended that the court is, after all, in the best position to judge the merits of a case which it has just decided. The argument may beg the question, for the answer is made that if a private individual can collect a fee by acting as a private attorney general, there is no need to grant tax exemption to an organization performing the same function. The need for a tax-exempt organization may be to undertake the cases which, because of their expense or significant hazards of litigation, are not likely to be risked by private sources and in which the public significance of the action dominates all other interests.

If it is true that a statutory authorization of the payment of attorneys' fees will encourage litigation to enforce the statute, then it must also follow that the creation of any rule, statutory or judicial, authorizing the award of fees will encourage litigation productive of such fees. This encouragement would be equally applicable to tax-exempt organizations permitted to collect such fees and could therefore influence the nature of their activities. It has been suggested that this is a desirable result because the fees are awarded when the action taken has been in the public interest. The counter argument is that the influence may be so great as to direct public interest groups into these areas, in which private citizens can also participate, at the expense of other areas in which representation is needed but no court-awarded fees are available.

The different types of public interest law organizations would be affected in different ways by the collection of legal fees. Some organizations contend that legal fees are essential to their survival (and, if so, the need will exert a powerful influence on the selection of cases). Others have established sources of contributions and regard legal fees as a source of new money for expansion of operations. Because federal statutory law prohibits the award of fees against the United States (except where expressly authorized by special statute), the organizations dealing primarily in litigation against the United States would attach more significance to the ability to collect fees from clients than to court-awarded fees against defendants. In the traditional view of the IRS the differing consequences to various organizations are not relevant to a resolution of the basic issues. The IRS approach is that questions of this type should be resolved on technical grounds, that is, solely by reference to a consideration of the standards necessary to comply with the "exclusively charitable" requirement and to avoid prohibited private inurement and improper competition. To the extent policy considerations dictate a different result, a change in the statutory standards becomes necessary.

It has also been suggested that the ability to collect court-awarded fees would encourage bypassing the administrative processes in favor of commencing litigation at the earliest possible moment. One safeguard against such a result is the requirement applicable in most litigation that a party must exhaust his administrative remedies as a condition precedent to filing suit. Another possible safeguard would be for a court to refuse to award a fee unless the litigation obtained something more than could have been obtained through administrative processes. Yet another would be to authorize administrative agencies to pay legal fees to persons and organizations appearing before the agencies and achieving a result determined to be in the public interest. These are, however, matters for resolution by legislatures and courts and are not matters of tax policy.

Many public interest lawyers complain that the cost of fund raising is high and diverts time and energy from the charitable purposes of the organization. This is not, however, a matter unique to public interest law groups since all charities seeking public support must make such efforts.

Earlier in the discussion of public interest litigation it was noted that "publicly supported" charities occupy a preferred status under the tax laws. As already noted such organizations generally are those that receive annually one third of their support from public contributions. For purposes of determining support, receipts derived from the organization's exempt function (such as admission fees and sales of merchandise) are not taken into account. Thus, an organization receiving two thirds of its support in the form of investment income and one third of its support from numerous small public contributions would normally qualify as a publicly supported charity. Section 509(a) (2) also describes another type of charity that qualifies for preferred status, namely, a broadly supported organization. This type of organization is one that receives at least one third of its support from a combination of contributions and gross receipts from exempt activities and does not receive more than one third of its support from investment income. Both publicly supported and broadly supported organizations are excluded from the definition of "private foundation." It has been suggested that rules of a similar type could be developed for public interest law groups to provide for a balance between public support (in the form of contributions) and legal fees. It would seem, however, that such a rule should be mandatory only if it is determined, as a matter of policy, that the receipt of public contributions is essential to ensure that a public interest law group will operate for exclusively charitable purposes. It would be necessary in applying any such rule to develop flexible operating rules to take into account the fact that a fee collected in one year could represent the result of legal services rendered over a great many years (that is, there should be some mechanism for allocating the fee over the years in which efforts were expended to produce the fee). It should also be borne in mind that requiring responsiveness to contributors is, in any particular case, inconsistent with a lawyer's obligation to serve only the interests of his client.

Finally, there is the matter of the tax consequences that would arise should the courts develop a rule that public interest law organizations (other than those acting solely in the capacity of counsel) should pay the legal fees of opposing parties in suits in which the public interest organization is found not to have acted in the public interest. Without going into the merits of such a rule, it is worth noting that the development of the rule has substantial constitutional issues (in terms of a citizen's free access to the courts), but this is essentially a question for resolution by the judiciary and the bar, not the tax laws. It would seem that the award of fees against a public interest law group would not raise a tax policy issue unless such awards arose as the result of a program of illegal or improper conduct, in which case the organization could face a revocation of tax-exempt status on the ground that its operations were no longer for exclusively charitable purposes.

Analogy to schools and hospitals. It has been argued that schools and hospitals collect substantial amounts of fees from the rendition of services and that by analogy the tax law should permit public interest law groups to collect legal fees. There appear to be two principal reasons why the receipts of schools and hospitals are not analogous to attorneys' fees of public interest law organizations.

Education and health care are themselves charitable purposes, while legal representation is not *per se* a charitable activity. The tax exemption and the permissibility of the collection of substantial fees apparently rest on the overriding importance of education and health care to the welfare of our society. Legal representation does not yet seem to have reached the same level of importance although, as noted earlier in this report, the delivery of legal services is a subject receiving increasing attention.

Second, there is the significant difference, already described, in the institutional nature of the respective types of organizations. Schools and hospitals are institutions, not people, and as such are subject to certain rules not necessarily appropriate for personal relationships. For example, under recent court decisions, private schools must, to retain their tax-exempt status, adopt an admissions policy that does not discriminate on the basis of race[72] and hospitals must render emergency care to all persons and may be required to render at least some free health care.[73] Lawyers, on the other hand, are people who must serve their clients in an attorney-client relationship which is a very personal, not institutional, relationship. The lawyers are themselves analogous to teaching faculties and doctors, who are non-exempt taxpayers, not to the institutions for which the faculties and doctors work. Charitable legal representation does not yet have anything similar to the hospital buildings and equipment or the educational campuses and facilities and it is the entities owning such physical plants to which tax exemption is granted.

From whom would fees be collected? The potential sources of fees for public interest law organizations appear to be three: (1) governmental-agency defendants, (2) nongovernmental defendants, and (3) clients, which may include governmental agencies, other tax-exempt organizations, and private persons. "Defendants" is used herein in the general sense of "opposing parties"; it should be noted that in certain cases the fees may be awarded against plaintiffs.

The collection of fees from governmental-agency defendants encounters some substantive problems. There is a general statutory prohibition against a court's awarding fees against the United States unless specifically authorized by law to do so.[74] At the present time there are 29 federal statutes providing for or requiring the award of attorneys' fees, including most of the new environmental and consumer laws.[75] There are also cases that raise a question whether a federal court is constitutionally prohibited from awarding fees against an officer or agency of a state government.[76] The federal prohibition can of course be amended by Congress, and the Senate Subcommittee on Representation of Citizen Interests, chaired by Senator Tunney (California), has held extensive hearings on the matter and is considering legislation on the subject. A constitutional prohibition with respect to the award of fees against a State would require a constitutional amendment or the consent of the State involved in a particular action.

In the area of tax policy, the collection of fees by a public interest law organization from a governmental agency can in many cases be supported on the ground that, to be entitled to such a fee, the organization must first win the case on the merits and then satisfy the court that its action meets the applicable statutory or judicial standards for the award of fees. A private citizen could achieve the same result, but, assuming the other elements of public interest litigation are present, surmounting these obstacles would evidence the public benefit of the organization's actions. It is also contended that a government (federal or state) is in the best position to spread the economic burden of the fees; this argument may appear to run counter to the basic policy in environmental matters that the cost of environmental improvement should be reflected in market prices, but on closer analysis it will be seen that the fees are awarded as compensation for the legal representation – a charitable activity – and only secondarily because of the environmental or other public benefit. Moreover, the granting of tax exemption to an organization seeking environmental improvement is a departure, and a universally accepted departure, from such basic policy. Finally, the point is made that in suits against a governmental agency there is no public attorney general, as such, because the governmental attorney general is defending the agency being sued; in such cases only plaintiffs or friends of the court can present public interests to the extent such interests are inconsistent with the governmental positions.

With respect to the collection of fees awarded against nongovernmental defendants (as in the TAPS case), the focus would seem to return to whether the litigation was, in the first place, proper public interest litigation (that is, when is it charity to sue a private party?). Where a private economic interest could normally be expected to undertake particular litigation and to secure an award of fees, it is doubtful that the litigation would meet the standards for public interest litigation. Where, however, the public interest litigation standards have been met and a substantial public benefit has been obtained, an award of fees against a private party would, for tax purposes, appear to be comparable to fees awarded against a governmental agency.

The collection of fees from clients (which, as noted above, may include governments, charities, and private persons) poses the hardest questions. Observe, however, that they arise only in the case of "law firms," not in the case of organizations suing in their own names as their own clients (or having as "clients" members whose economic interest in the litigation is nominal).

Looking first at charitable clients, if the litigation is in furtherance of the client's charitable purposes, is it charity for a public interest law firm to receive a fee for representing the client to advance those purposes? It is clear that a charity could use its tax-exempt funds to employ its own staff attorneys to handle its litigation when the volume thereof is sufficient to warrant such employment (this is, in fact, the case with many public interest law organizations). By analogy it is argued that those same funds should be usable to employ a charitable law firm to furnish the legal services. Where the charitable client has the financial resources to pay in full the customary private legal fee, the public interest law firm would be in direct competition with private lawyers who could render the same service. In this case, however, tax exemption does not appear to furnish a competitive advantage because the fees themselves come from tax-exempt funds and are being spent in furtherance of tax-exempt purposes. We would suggest, therefore, that as a technical legal matter it would be within the parameters of charity for a public interest law firm to receive a fee for representation of another charity, whether the fee is equal to or less than that which a private lawyer would charge, simply on the ground that the client's tax-exempt funds are being used (and after receipt by the public interest law firm will continue to be used) for charitable purposes. The result may be different, however, with respect to nonpublic interest litigation in which the charitable client is merely seeking redress against a private party for a wrong committed against the charity or its property — such litigation seems more closely akin to litigation between private interests than to a charitable activity.

Are fees from a governmental client distinguishable from fees payable by a charitable client? The answer may turn on the nature of the suit or activity for which the fee is paid because governments engage in many proprietary activities in addition to their public welfare functions. In legal matters involving exclusively public purposes (which purposes fall within the tax law's definition of charitable purposes), a fee from a governmental client is fully comparable to a fee from a charitable client. Representation of a government in an essentially proprietary matter would appear to fail the test of public interest litigation and thus the question of a fee would never be reached.

This leaves, then, the matter of fees from private parties, the most difficult problem of all. While the right to collect any fees at all will exert an influence on the nature of an organization's practice, the receipt of fees from paying clients will bring into being the additional ingredient of the client's influence, an influence potentially greater than that of non-paying clients. Moreover, unlike the first two client situations considered, the funds are coming from private sources, not already tax-exempt sources, and here the danger is greatest that the legal representation may shift to a representation of private interests as opposed to a public interest. Again, however, this consideration leads back to the analysis of identifying the public interest (charitable) legal representation. Many public interest lawyers have conceded that the direct representation of private interests financially capable of retaining private counsel would not be a charitable activity, even in cases involving issues of broad public significance. Under the criteria for public interest litigation described in Chapter V of this report, a private interest, to qualify for representation by a tax-exempt organization, must have limited financial resources; if the propriety of the test be assumed, then it follows that fees from private interests must be based on an ability-to-pay standard, and the line would be drawn at the point where the private interest is unable to secure private counsel.

Such a result finds support in the regulations defining the term "charitable":[77]

> The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes.

As noted below, however, the IRS has recently concluded that a public interest law organization may not collect fees from clients.

There is yet another consideration which differentiates client fees from court awarded (or statutorily approved) fees. The latter fees are paid only after an outside institution, the court or the legislature, has weighed the relevant factors, and there will usually be no element of certainty in their collection. The factors to be weighed may include consideration of the payee's status as a tax-exempt charitable organization. In contrast, client fees will not be subjected to the same review, unless and until the Congress legislates on the subject. Even after legislative approval there would be no case-by-case review of fees, unless the legislation provided for such review, and the fees may be definitely fixed at the inception of a matter.

We might add that the legal profession could assist by developing procedures for certifying or representing to public interest law organizations those individuals who have insufficient resources to retain private counsel. Such procedures could utilize legal aid societies, lawyer referral committees, bar associations or the like and could be recognized for tax purposes in determining whether the public-interest criteria have been met. The "attorneys' fees" rules in Chapter V incorporate such a standard. It would be unwise to make such certifications or representations mandatory in all cases, but their availability could go a long way toward solving many of the problems surrounding the receipt of client fees.

Finally, we observe that authorization to collect client fees would have tax consequences to the payor clients. Whereas voluntary contributions, of the type described in the regulation quoted above, are deductible as charitable contributions, legal fees are not deductible unless constituting an expense of an activity for which deductions are allowable. Consequently, an amount received by a public interest law organization as an attorney's fee from a client should be characterized for the client's tax purposes as a legal fee and not as a charitable contribution. This characterization may have an effect on the client's ability to pay.

Determining the amounts of legal fees. If it is assumed that legal fees are properly collectible by public interest law organizations, a problem arises with respect to determining the amount of the fees properly collectible.

The determination of an attorney's fee is usually based on a consideration of the time and effort involved, the responsibility assumed, the difficulty of the matter, the attorney's expertise and, in appropriate cases, the results achieved. Note, however, that an attorney's only product is his time and skill and that the factors involved in setting his compensation include, of necessity, a profit element – fees are his sole source of professional income. Are the same standards appropriate for a fee payable to a tax-exempt organization?

Since employee-attorneys of a charitable employer cannot, by reason of the private inurement prohibition, participate directly in the fees collectible by the employer, their compensation can normally be expected to be based on a salary (or other fixed-rate) arrangement. Should the employer-charity receive a fee providing an element of profit over and above its salary and other costs? On the one hand it can be argued that the charity's court-awarded fee should be based solely on the value of its service, as determined by the court employing customary professional standards, without regard to whether the amount so determined returns a profit to the charity. It can be questioned, on the other hand, whether tax exemption should not require the fee to be based on a principle of cost reimbursement (but not to exceed the commercial value).

We believe the issue is one of tax policy which could be resolved either way within the framework of existing law. Many charities derive net income from certain charitable activities (for example, admission fees or sales of property) and use such income to subsidize other charitable activities, and the practice is unquestionably proper under present law. Other charitable activities provide a charitable service or product at or below cost, or without any charge (a free lending library, for example). So long as the litigating activity satisfies the public interest criteria and rules, it would appear that a public interest law organization could, without violating existing law, receive a court-awarded fee based on either a value or a cost (or less) approach.

Recent IRS action and summary of policy questions. In early October 1974 the IRS issued its first private rulings on the subject of a public interest law organization's collection of legal fees. Rulings issued to two public interest "law firms" approved the receipt of attorneys' fees awarded by a court (or an administrative agency) against a defendant or provided for in a court-approved settlement agreement; the rulings hold that the payments may be based either on statutory authority for the award of such fees or the equitable powers of the courts to make such awards. Each of the rulings contained the following paragraph (the numbers in brackets have been added by us):

> [1] This ruling is issued with the understanding that neither the expectation nor the possibility, however remote, of an award of fees will become a substantial motivating factor in your selection of cases. [2] As legal precedent is developed indicating the strong probability of the recovery of fees in a particular type of public interest case, the litigation will be deemed to be economically

> feasible for clients and your public interest law firm will be expected to defer accepting the case in favor of private law firms. [3] In addition, no more than 50 percent of your total costs of legal functions (attorneys' salaries, nonprofessional salaries, rent, and other costs directly attributable to the performance of your legal functions) should be defrayed from awarded fees. [4] This percentage will be calculated over a five year period, including the taxable year in which any awarded fees are received and the four preceding taxable years (or such lesser period of your existence if you have not been in existence for four preceding years). You may, however, submit a ruling request to the Service if you feel that an exception to this 50 percent limitation is warranted by any unusual circumstances. [5] Of course, no fees should be accepted in any cases which might result in any conflicts with state statutes or professional canons of ethics.

Points 1 and 2 in the quoted language are consistent with the criteria, discussed at length above, for determining public interest litigation. The receipt of fees should be incidental to the prosecution of a case satisfying the criteria, not a reason for selecting the case, and the "strong probability" of the recovery of fees is certainly a factor bearing on whether the clients are represented. Point 5 is, of course, related to the prohibition against a program of improper (noncharitable) conduct.

The third and fourth points are the most noteworthy because they represent the policy determination of the IRS on the question whether a public interest law firm should be able to become self-supporting from the collection of attorneys' fees. The Service apparently believes that a self-sufficient public interest law firm would be too closely akin to the taxpaying public interest firms to be charitable and, perhaps, that self-sufficiency would be indicative of the selection of cases on the basis of the availability of legal fees. The line was drawn at 50 percent of the organization's litigating budget, based on a 5-year moving average. To be contrasted with this percentage (in effect requiring 50 percent support from contributions and other receipts) are the one-third standards (described earlier) set by Congress for "publicly supported" and "broadly supported" organizations; while the latter standards are based on a distinction between investment income and other forms of support, they are significant as indicating the level at which Congress believes the impact of public support is sufficient to justify an organization's receiving a preferred status.

The rulings also hold that the organizations may be reimbursed by clients or opposing parties for out-of-pocket expenses, such as expert witness fees, printing and duplicating costs, filing fees, travel and telephone expenses, and the like. The two organizations did not request a ruling with respect to the receipt of fees from clients, but a third organization (dealing extensively with the federal government and therefore frequently unable to obtain court-awarded fees from the government) made such a request. The request sought approval for the collection of fees, not to exceed the organization's actual costs, from clients who are unable to pay enough to retain private counsel. In denying the request the IRS explained:

> The basis for the charitable recognition of a public interest law firm rests not on the social merits of the particular positions being advocated by the firm but rather on the fact that such an organization provides a facility for the resolution of issues of public interest importance. Because these cases do not entail any significant economic interest, traditional commercial sources do not provide adequate legal representation for the resolution of such issues.
>
> This rationale is reflected in section 3.01 of Rev. Proc. 71-39, *supra*, which contains explicit provisions preventing the public interest law firm from providing legal services with respect to issues which warrant utilization of conventional legal services. Therefore, the touchstone of charitability of public interest law firms is that they provide a type of representation which, because it is not economically feasible, is not available from traditional law firms. We feel that if public interest law firms were allowed to charge or accept fees from clients, the

receipt of such fees or the potential for such fees could well become a significant purpose of the litigation with the consequent erosion of the basis for charitable classification and detriment to the community in terms of the issues or parties selected for representation. This expectance of fee recovery is necessarily inconsistent with charitability in the context of public interest law firms.

The Service has thus concluded that the potential influence of clients, who can pay something but not enough to hire a lawyer, would be too great on the selection of cases and issues to be pursued. We suspect, however, that the influence of modest client fees is potentially not as great as the influence of large court-awarded fees. It therefore appears to us that there is some inconsistency in the policy determinations underlying the respective rulings. Nevertheless, as we noted earlier, client influence is different in character from the pure economic influence of court awards of fees, and this factor, together with the Service's administrative problems, must be weighed in making any policy decision.

The foregoing policy determinations are now reflected in Rev. Proc. 75-13, 1975-1 C.B. 662 and are further explained in Rev. Rul. 75-75, 1975-1 C.B. 154, and Rev. Rul. 75-76, 1975-1 C.B. 154. Rev. Proc. 75-13 sets forth the following rules which, if followed, will satisfy the requirements of IRS Guideline 2:

1. The organization does not seek or accept attorneys' fees from clients.
2. The organization may accept fees from opposing parties when awarded by a court or agency or approved by such a body in a settlement agreement.
3. The organization does not use the likelihood or probability of a fee award as a consideration in its selection of cases.
4. The organization uses awarded fees exclusively for the purpose of defraying its normal operating expenses. Awarded fees are to come within the 50 percent rule described above unless the organization submits a ruling request for an exception.
5. Fees are paid to the organization, not the individual attorneys, and the compensation of attorneys is set on a reasonable salary basis, without reference to fees recovered.
6. The organization does not accept fees in any circumstances that would result in conflict with state statutes or professional canons of ethics.
7. The organization files with its annual tax return a report of all fees sought and recovered.

The 50-percent-of-support rule has already been discussed herein; this is strictly a judgmental matter on which reasonable men can differ. The client fees prohibition, however, deserves further comment.

Rev. Rul. 75-75 elaborates on the reason for the prohibition. The thrust of the analysis in the ruling is that the representation provided by a tax-exempt organization having a policy of accepting fees from clients cannot be distinguished from the representation available from private, taxpaying law firms. We have concluded earlier in this report that the two types of representation are distinguishable — the distinguishing feature being that, under the definition of public interest litigation described herein, representation by private lawyers is not available to the clients who would be paying the modest fee. The absence of private representation is one of the key ingredients supporting the charitable nature of public interest law, and the ingredient is just as much present in the case of the organization accepting client fees as it is in the case of the organization receiving substantial court-awarded fees.

There is, however, a problem, and a serious one, from the point of view of administering the tax laws. We have already described the elements of certainty and client influence involved in the issue of client fees, and earlier we alluded to some of the

Service's administrative problems. It appears to us that the inability to draw the distinction described in Rev. Rul. 75-75 is an administrative, not a legal, inability. In other words, if a mechanism could be developed for the receipt of client fees, a mechanism which would provide the IRS with some assurance for continued charitable operations and provide examining agents (and the organization, as well) some protection from having to make subjective judgments under the influence of hindsight, we believe the IRS would reconsider its prohibition against the receipt of client fees.

The participation of some outside agency might provide the necessary assurance and insulation. Thus, if a bar association or legal aid society were to determine that a particular client (or group) was unable to secure private counsel and so advised the public interest law firm, both the IRS and the public interest law firm would have evidence that, notwithstanding the payment of some attorneys' fee, certain of the key elements of public interest litigation have been satisfied. As noted earlier, this procedure is incorporated in the rules set forth in Chapter V. It may also be that others will be able to suggest alternative procedures that will solve the problems considered herein.

To summarize our discussion of the collection of attorneys' fees, the following appear to us to be the policy questions that must be resolved to establish operating rules for the collection of fees:

1. What mechanism is appropriate for establishing the compensation of staff attorneys?

2. Should a public interest law organization be able to become self-supporting from the collection of legal fees?

   a. A self-supported organization would cease to represent private philanthropy, in the sense of an organization voluntarily supported by contributions from private capital, and would be strongly motivated to engage in substantial "profitable" litigation.

   b. If the answer is in the negative, what percentage or other limitations are to be imposed?

3. Does the fact that the ability to collect fees will have an economic influence on the nature of an organization's activities pose any special concerns or require any special safeguards? Is a publicly representative board to determine policies and programs a sufficient safeguard?

4. Need there be different rules for different types of organizations (for example, "law firms" vis-a-vis membership organizations)?

5. Should public interest "law firms" be entitled to collect fees from the following types of clients:

   a. Charitable clients when the litigation is for charitable purposes?

   b. Governmental clients when the litigation is for public (charitable) purposes?

   c. Private parties who have insufficient resources to employ private counsel?

6. Should legal fees awarded by a court to a charitable organization merely reimburse the organization for its salary and other costs or may they be based on the value of the services (which may return to the charity a profit over and above its costs)?

V

DISCUSSION DRAFT OF CRITERIA AND RULES FOR DETERMINING PUBLIC INTEREST LITIGATION

The following material is presented to provide a framework for the development of a workable set of criteria and rules for the organization and operation of tax-exempt public interest litigation organizations and to provide points of reference for the preceding text. Where a particular rule can be formulated only after resolution of a policy issue discussed in the text, a portion of the rule is emphasized to identify the requirement or restriction which is dependent upon resolution of the issue.

For litigation activities to come within the term "charitable," as used in section 501(c) (3), the tax-exempt organization engaging in such activities must be participating therein to advance the public interest. The advancement of the public interest is to be determined by reference to the role of the organization in the litigation, not with reference to the particular cause of the persons who may be represented by the organization. The determination of whether the organization's role in the litigation is in the public interest is to be made on the basis of the three basic criteria set forth below and by the application of the applicable rules set forth below. The term "litigation" as used herein includes proceedings before administrative agencies, as well as judicial proceedings.

Three Basic Criteria

One. The organization represents the interests of persons who are otherwise unrepresented, or at least underrepresented. Such persons may be those who have traditionally been regarded as proper objects of charity, such as the poor and distressed, the underprivileged and members of disadvantaged minorities, or may be persons who would not otherwise come within the classes of traditional objects of charity.

Two. The persons whose interests are being represented lack the financial resources to employ private legal counsel to conduct the particular litigation or the amount involved is so disproportionately small, compared to the anticipated cost of the litigation, that such persons could not reasonably be expected to assume such cost.

Three. The particular litigation has significance for a substantial segment of the public. Such significance may be the rule of law to be determined by the court or agency or may be the subject matter of the suit, such as the protection of important resources or the enjoining of governmental or private conduct in violation of statutory law.

Applicable Rules

Application of the Criteria

The three basic criteria are to be applied in accordance with the following rules:

1. Where the persons whose interests are being represented are within the classes of traditional objects of charity, or where the person being represented is another sec-

tion 501(c) (3) organization acting in furtherance of its exempt purposes, such representation by the organization is a charitable activity in the public interest.

2. Where the persons represented are not within the classes of traditional objects of charity, the determination of whether the organization's role in the litigation is in the public interest is to be based on a relative weighting of the three criteria as follows:

a. The smaller the number of persons described in criterion one, the greater should be the significance described in criterion three.

b. The larger the number of persons directly affected and the smaller their economic interests and financial resources, the lesser is the need for significance of the case to others not directly involved in the litigation.

c. In an action against a private individual or entity, the plaintiffs' economic interests should be comparatively small and the public significance should be substantial. If the relief sought in a particular case includes an award of damages to the persons being represented by the organization, the potential size of the award and the likelihood of recovery are important factors to be considered in determining whether the organization's participation therein is on behalf of a private interest rather than in furtherance of the public interest.

d. If the organization is itself a party to a particular case, the economic interest of the case to any of the organization's members or contributors should be small in comparison to the significance described in criterion three.

3. The likelihood of the recovery of damages or attorneys' fees in a particular case is an important factor to be considered in determining whether the persons represented by the organization would otherwise have adequate representation.

Organizational Rules

The organization may have any organizational structure it chooses, and may or may not be authorized under applicable local law to engage in the practice of law as an organization, so long as the following requirements are met:

1. *The policies and programs of the organization shall be determined by a board or committee which is representative of broad segments of the community and which is not controlled by the employees of the organization or by any other organization that is not a section 501(c) (3) organization.*

2. The organization must *not be organized or operated in such manner as to create identification or confusion with a particular private law firm or other private enterprise.*

3. The organization must not be organized or operated to provide, directly or indirectly, a deduction for the cost of litigation which is for the private benefit of a donor.

Operational Rules

The operations of the organization shall be conducted in accordance with the following rules:

1. The selection of cases in which the organization will participate and the role of the organization therein are to be determined by the organization. The organiza-

tion must be prepared to substantiate its determination that its participation in each case satisfies the three basic criteria and the applicable rules.

2. The relief sought by the organization in a particular case may include injunctive relief against governmental authorities or private persons, or monetary damages on behalf of persons represented by the organization, so long as the organization's participation in the case satisfies the three basic criteria and the applicable rules. Except where the organization is suing as a private litigant for redress of a wrong committed against it, monetary damages payable directly to the organization should not be sought unless the damages are nominal and a judgment for such damages is necessary to achieve the proper objectives of the case.

3. The organization shall not engage in a program of disruption of the judicial system, illegal activity, or violation of the applicable standards of professional ethics and conduct. For this purpose, "program" means a regular course of conduct and does not include an isolated instance of unintentional or accidental misconduct.

4. The compensation of the organization's employees shall not be based on or measured by the attorneys' fees or other receipts collected by the organization. Attorneys' fees and other amounts (other than reimbursements of actual out-of-pocket expenses) payable by someone other than the organization to an employee for services rendered within the scope of such employee's employment by the organization shall not be retained by such employee and shall be regarded as the earnings or receipts of the organization. *The compensation of employees shall be determined by the board or committee responsible for determining the organization's policies and programs* and may be paid only for personal services that are reasonable and necessary to carrying out the exempt purpose of the organization and shall not be excessive in amount.

5. The organization shall otherwise comply with the provisions of section 501(c)(3) in that no part of its net earnings shall inure to the benefit of any private shareholder or individual, no substantial part of its activities shall be carrying on propaganda, or otherwise attempting, to influence legislation, and it shall not participate in, or intervene in, any political campaign on behalf of any candidate for public office.

Attorneys' Fees

The organization may collect amounts paid as attorneys' fees so long as it complies with the following rules:

1. Attorneys' fees *should not normally exceed an amount equal to 50 percent of the organization's total costs of its legal activities* (attorneys' compensation, nonprofessional compensation, rent and other costs attributable to the performance of such activities). *The percentage is to be calculated with respect to each year on the basis of a five-year (or such lesser number of years during which the organization has been in existence) moving average*, the five-year period consisting of the year in question and the four immediately preceding years.

2. The organization may accept reimbursement from clients or opposing parties for out-of-pocket expenditures for expert witness fees, printing and duplicating expenses, filing fees, travel expenses, telephone tolls, and the like.

3. Attorneys' fees *may be accepted from governmental or private opposing parties when awarded by a court or paid pursuant to a court-approved settlement agreement*, whether or not the payment of such fees is based on a statutory provision authorizing such payments.

4. Amounts received as attorneys' fees *may be accepted from clients only in cases in which (a) the client is a governmental agency or a section 501(c) (3) organization and the organization's representation of the client is in furtherance of a public, charitable, or other exempt purpose, or (b) the client or clients are private persons who individually and collectively are unable to employ private counsel to conduct the particular litigation.* If a local bar association, legal aid society or other similar organization certifies or represents that certain persons lack the financial resources to employ competent private counsel, or are unable to employ such counsel because of the anticipated cost of the matter, *the organization may rely on such certification or representation in applying the criteria and in accepting amounts paid as attorneys' fees.*

5. Except in the case of attorneys' fees paid by clients who are private persons, *attorneys' fees may be measured by the value of the services rendered by the organization (as determined under the standards applicable to private attorneys)* or may be measured by the organization's costs incurred in the particular legal activity. *Attorneys' fees paid by private clients would normally be expected to be less than the organization's costs* and, in any event, must be less than the amount that would be charged by competent private counsel.

6. The prospect of collecting attorneys' fees should not become a substantial motivating factor in the selection of cases to be undertaken by the organization.

Acknowledgments

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A.M. Wiggins, Jr.

Footnotes

1. Section 501(c) (3) grants exemption from federal income tax to the following:

   (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

2. Reg. § 1.501(c) (3)–1(d)(2) provides that the term "charitable" includes:

   Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

3. Reg. § 1.501(c) (3)–1(d) (3) (i).
4. See Reg. § 1.501(c) (3)–1(d) (5).
5. Reg. § 1.501(c) (3)–1(d) (1) (ii).
6. Reg. § 1.501(c) (4)–1(a) (2).
7. Rev. Rul. 67-109, 1967-1 C.B. 131.
8. Rev. Rul. 69-384, 1969-2 C.B. 122, and Rev. Rul. 68-118, 1968-1 C.B. 261.
9. Rev. Rul. 66-273, 1966-2 C.B. 222.
10. Rev. Rul. 71-530, 1971-2 C.B. 237.
11. F. Grad, *Environmental Law* § 1.01, at 1-4 (1971).

12. 14 Stat. 251 (1866), as amended, 30 U.S.C. §§ 21-26 (1970).

13. 17 Stat. 91 (1872), as amended, 30 U.S.C. §§ 21-26 (1970).

14. See, e.g., letter dated January 15, 1969, from the Secretary of the Interior to the Public Land Review Commission, reprinted in F. Grad, *Environmental Law* § 10.03[2], at 10-74 (1971).

15. 36 Stat. 847 (1910), as amended, 43 U.S.C. §§ 141-42 (1970).

16. 41 Stat. 437 (1920), as amended, 16 U.S.C. §§ 181 et seq. (1970).

17. 26 Stat. 1103 (1891), as amended, 16 U.S.C. §§ 471 et seq. (1970).

18. 74 Stat. 890 (1964), as amended, 16 U.S.C. §§ 1131-36 (1970).

19. 30 Stat. 1152 (1899).

20. See F. Grad, *Environmental Law* § 2.03[2], at 267 (1971).

21. 43 Stat. 604 (1924).

22. Federal Water Pollution Control Act, Act of June 30, 1948, c. 758, 62 Stat. 1155, as amended, 33 U.S.C. §§ 1251-1376 (Supp. II, 1972).

23. Air Pollution Control, Research and Technical Assistance Act, 69 Stat. 322 (1955).

24. Rev. Rul. 54-466, 1954-2 C.B. 93.

25. I.R.S. News Release No. 784, November 15, 1965.

26. Rev. Rul. 67-292, 1967-2 C.B. 184.

27. Rev. Rul. 67-391, 1967-2 C.B. 190.

28. Rev. Rul. 67-293, 1967-2 C.B. 185.

29. Rev. Rul. 68-14, 1968-1 C.B. 243.

30. Rev. Rul. 68-307, 1968-1 C.B. 258.

31. Rev. Rul. 70-186, 1970-1 C.B. 128.

32. Rev. Rul. 72-560, 1972-2 C.B. 248.

33. Pub. L. No. 91-190 (1970), 42 U.S.C. §§ 4321-47 (1970).

34. Clean Air Act Amendments of 1970, Pub. L. No. 91-604, 42 U.S.C. §§ 1857 et seq. (1970).

35. Federal Water Pollution Control Act Amendments of 1972, Pub. L. No. 92-500, 86 Stat. 816, 33 U.S.C. §§ 1251-1376 (Supp. II, 1972).

36. See, generally, *Report of the Tax Policy Advisory Committee to the Council on Environmental Quality* (February 1973).

37. See *The President's 1972 Environmental Program*, 39-66 (March 1972).

38. Created by Pub. L. No. 92-500, § 12, 33 U.S.C. § 1281 (Notes) (Supp. II, 1972).

39. Council on Environmental Quality, *Environmental Quality–Fourth Annual Report of Council on Environmental Quality*, 402-03 (September 1973) (hereinafter cited as "*Environmental Quality*").

40. As reported in *Environmental Quality*, supra at 387.

41. Regs. § 1.501(c) (3) –1(d) (3) (i).

42. See I.T. 2134, IV-1 C.B. 214; Rev. Rul. 67-391, 1967-2 C.B. 190.

43. Section 513(a) provides that an unrelated trade or business is any trade or business the conduct of which "is not substantially related" to the organization's exempt purposes. Under Reg. § 1.513-1(d) (2), the touchstone for determining whether a trade or business is "substantially related" to an organization's exempt purposes is whether the activity "contribute[s] importantly to the accomplishment of those purposes."

44. In American Association of Fund-Raising Counsel, Inc., *Giving U.S.A., 1973,* it is reported that conservation received less than 1% of 1973 American philanthropy totaling $24.53 billion.

45. See 2 *American Law of Property* § 8.5 (1952).

46. For an emminently readable explanation of many of the esoteric real property rules (which are defined legally in language understood only by some real estate conveyancers and a few law students and their professors), see Brenneman, *Private Approaches to the Preservation of Open Land* (The Conservation and Research Foundation, 1967).

47. By November 1973, 31 states had enacted statutes providing for some form of property tax relief for farmland and/or open space land. The property tax relief for open space land is usually obtained by the owner's entering into a restrictive agreement with a governmental agency and such agreements thereby create conservation benefits. For a digest and discussion of these laws, see Hady and Sibold, *State Programs for the Differential Assessment of Farm and Open Space Land* (U.S. Department of Agriculture, Agricultural Economic Report No. 2[illegible]6, April 1974).

48. Reg. § 1.170A-7(b) (1) (i).

49. Reg. § 1.170A-7(b) (1) (ii). Similar rules are provided in section 2522(c) (2) and Reg. § 25.2522(c)–3(c) (2) (i) with respect to the gift tax charitable deduction and in section 2055 (e) (2) and Reg. § 20.2055-2(e) (2) (i) with respect to the estate tax charitable deduction.

50. Rev. Rul. 73-339, 1973-34 I.R.B. 6.

51. Reg. § 1.170A-7(b) (1) (i).

52. P.L. 91-172.

53. S. Rep. No. 91-552, 91st Cong., 1st Sess., p. 84.

54. Conf. Rep. No. 91-782, 91st Cong., 1st Sess., p. 294.

55. See H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess., p. 60-61.

56. See Ibid., pp. 58-59.

57. See Ibid., pp. 57-58.

58. Section 170(f) (3) (B) (i).

59. The only significant risk of loss to charity in the case of a remainder interest in real property would be from depreciation or destruction of improvements or the removal of soil, minerals or timber, and section 170(f) (4) makes clear that these factors are to be taken into account in valuing the interest contributed to charity.

60. See *The President's 1973 Environmental Program* at 301 (Council on Environmental Quality, April 1973).

61. Pub. L. No. 93-153, 87 Stat. 576.

62. *Wilderness Society v. Morton,* 495 F.2d 1026 (D.C. Cir. 1974), *cert. granted sub nom:. Alyeska Pipeline Serv. Co. v. Wilderness Society,* 421 U.S. 240 (1974), 43 U.S.L.W. 3208 (October 15, 1974).

63. Reg. § 1.501(c) (3)–1(d) (2).

64. *NAACP* v. *Button*, 371 U.S. 415, 428-29 (1963); see *Brotherhood of Railroad Trainmen* v. *Virginia*, 377 U.S. 1 (1964).

65. Section 2 of the Legal Services Corporation Act of 1974, Pub. L. No. 93-355, 42 U.S.C. §§ 2996 et seq. (1974), provides as follows:

> The Congress finds and declares that—
>
> (1) there is a need to provide equal access to the system of justice in our Nation for individuals who seek redress of grievances;
>
> (2) there is a need to provide high quality legal assistance to those who would be otherwise unable to afford adequate legal counsel and to continue the present vital legal services program;
>
> (3) providing legal assistance to those who face an economic barrier to adequate legal counsel will serve best the ends of justice;
>
> (4) for many of our citizens, the availability of legal services has reaffirmed faith in our government of laws;
>
> (5) to preserve its strength, the legal services program must be kept free from the influence of or use by it of political pressures; and
>
> (6) attorneys providing legal assistance must have full freedom to protect the best interests of their clients in keeping with the Code of Professional Responsibility, the Canons of Ethics, and the high standards of the legal profession.

66. Hearings Before the Subcommittee on Employment, Manpower, and Poverty, "Tax Exemptions for Charitable Organizations Affecting Poverty Programs," pp. 71-72 (1971).

67. See *United States* v. *Students Challenging Regulatory Agency Procedures*, 412 U.S. 669 (1973).

68. See *Sierra Club* v. *Morton*, 405 U.S. 727 (1972).

69. See *Natural Resources Defense Council, Inc.* v. *EPA*, 507 F.2d 905 (9th Cir. 1974).

70. Section 170(b) (1).

71. Detailed rules for determining whether an organization is "publicly supported" are contained in Reg. § 1.170A-9(e).

72. See *Green* v. *Connally*, 330 F. Supp. 1150 (D.C. D.C.), *aff'd sub nom. Coit* v. *Green*, 404 U.S. 997 (1971).

73. See *Eastern Kentucky Welfare Rights Organization* v. *Shultz*, 370 F. Supp. 325 (D.C., D.C. 1973), rev'd 506 F.2d 1278 (D.C., Cir. 1974); Rev. Rul. 56-185, 56-1 C.B. 202, modified by Rev. Rul. 69-545, 69-2 C.B. 117.

74. 28 U.S.C. § 2412 provides in part: "Except as otherwise specifically provided by statute, a judgment for costs, as enumerated in section 1920 of this title but not including the fees and expenses of attorneys may be awarded to the prevailing party in any civil action brought by or against the United States or any agency or official of the United States acting in his official capacity. . . ."

75. The statutes are collected and reprinted in III *Hearings Before the Subcommittee on Representation of Citizen Interests*, 93rd Cong., 1st Sess., pp. 1267-78 (1974).

76. See *Edelman* v. *Jordan*, 415 U.S. 651 (1974), which held that a State's Eleventh Amendment immunity from suit in a federal court bars the entry of a federal court judgment against a State officer, the effect of which would require the State to pay its public funds to individuals who were previously denied benefits under a joint federal-state welfare program in violation of the applicable federal law. The Supreme Court noted that a judgment, even though entered against

an officer of the State, was in practical effect a judgment against the State and that any such judgment may, under the Eleventh Amendment, have prospective effect only. The principle barring a retroactive monetary award against a State could conceivably bar an award of attorneys' fees against a State (or State officer) at the conclusion of a federal court action.

77. Reg. § 1.501(c) (3)–1(d) (2).

AN ANALYSIS OF THE FEDERAL TAX DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITABLE ORGANIZATIONS

Laurens Williams[†] and Donald V. Moorehead*

Introduction

Section 501(c)(3) of the Internal Revenue Code[1] provides for exemption from federal income taxes, under section 501(a), for those organizations organized and operated exclusively for charitable and other specified purposes.[2] Of the many categories of tax-exempt organizations, section 501(c)(3) is one of the largest. Exemption under this section is particularly significant because contributions to organizations described therein (except organizations whose function is to test for public safety) may, with certain limitations, be deducted by the contributor for federal income, gift, and estate tax purposes.[3]

Although the basic tests for qualification under section 501(c)(3) are uniformly applied to all organizations,[4] the federal tax laws do draw numerous and significant distinctions among various types of section 501(c)(3) organizations. These distinctions include diverse treatment under the statutory provisions governing the income tax treatment of charitable contributions and the provisions applicable to "private foundations" (as defined in section 509(a)). Private foundations, unlike other section 501(c)(3) organizations, are subject to a tax on investment income. They are required to make annual public reports and to distribute annually for charitable purposes all of their net income or, if greater, an amount equal to a specified percentage of the value of their investment assets. Private foundations alone are also subject to substantive restrictions on financial practices and program activities. These include prohibitions on acts of self-dealing, excess business holdings, speculative investments, and any attempts to influence legislation, plus procedural restrictions on grants to individuals and certain other organizations.

This legal study traces the development of the distinctions between public and private charitable organizations in the federal tax laws. It also analyzes the asserted reasons for the present pattern of these distinctions with a view to developing the information necessary to permit an informed decision as to whether such distinctions as now exist are founded upon valid empirical evidence or other sound considerations of federal tax policy. The focus of this study is thus upon *distinctions* between classes of charitable organizations. Other legal studies prepared for the Commission examine the operation of, and justification for, particular substantive provisions of the Internal Revenue Code affecting charitable organizations.

Reference should be made to the manner in which the terms "public charity" and "private charity" have been utilized for purposes of this study. The two classes of organizations, taken together, have been defined to include all organizations described in section 501(c)(3), other than organizations which test for public safety, a comparatively small class of organizations which has been excluded from the analysis because they are not entitled to receive deductible contributions. (For convenience, we sometimes use the term "charitable organizations" to refer to all section 501(c)(3) organizations.) Thus, the term "charitable organizations" includes "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, . . . literary, or educational purposes, or for the prevention of cruelty to children or animals. . ."

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To facilitate our analysis, "public charities" have been distinguished from "private charities" by reference to the definition of the term "private foundation" in section 509(a). As will be explained in greater detail, section 509(a) treats every section 501(c)(3) organization as a "private foundation," with three general exceptions.[5] First, certain categories of organizations such as churches, hospitals, and schools are excluded from "private foundation" status. Second, exceptions are made for organizations that derive a substantial part of their support from the general public and from governmental sources. Third, an exception is made for organizations that are closely associated with, and integrally related to, other public charities. Section 501(c)(3) organizations that fail to qualify under one of these three exceptions are classified as "private foundations" for federal tax purposes and are regarded as "private charities" in this study.

I

DEVELOPMENT OF STATUTORY DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITABLE ORGANIZATIONS

Early Revenue Acts

The first congressional exemption for charitable organizations was enacted in the Income Tax Act of 1894.[6] Although that statute was declared unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895), it is noteworthy that it did contain, in section 32 of the act, an exemption for charitable, religious, and educational organizations. Similarly, the Corporation Excise Act of 1909,[7] which imposed a tax, measured by income, on the privilege of doing business, exempted from its coverage: ". . . any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."

The Sixteenth Amendment to the Constitution was ratified in February 1913 and Congress promptly enacted the Revenue Act of 1913,[8] the first of the so-called "constitutional" income taxes. Section II G(a) of the 1913 act contained language identical to that used in the 1909 act, quoted above, except that "scientific" was added to the list of exempt purposes. The exemption provision was expanded in 1918 to include "prevention of cruelty to children or animals"[9] and in 1921 to include "literary" purposes.[10]

The basic exemption provision was modified by the Revenue Act of 1934[11] to add the requirement that no substantial part of an exempt charitable organization's activities could consist of carrying on propaganda, or otherwise attempting to influence legislation. In the Internal Revenue Code of 1954, Congress added another condition to the exemption provision — a flat prohibition on participation in, or intervention in, campaigns for election to public office.

Congress also acted early to encourage contributions to charitable organizations. In 1917 a statutory provision permitting individuals to deduct charitable contributions for income tax purposes was enacted.[12] A provision authorizing corporate income tax deductions was enacted in 1935.[13] Estate and gift tax deductions for charitable transfers were authorized in 1918 and 1924, respectively.[14] The 1924 gift tax statute was repealed in 1926, but was reenacted in 1932 and, as reenacted, also contained provisions allowing deductions for charitable transfers.[15]

Although one class of charitable organizations — private foundations — had been strongly criticized by the so-called Walsh Commission in 1916, and although Congress had earlier declined to issue a charter to the Rockefeller Foundation, Congress made no significant legislative distinctions among classes of charitable organizations until 1943, when it required certain exempt organizations to file annual information returns.[16] Excluded from this filing requirement were churches and other religious organizations, certain educational institutions, and certain publicly supported organizations.[17] One apparent purpose of the 1943 legislation was to provide Congress with sufficient information to determine the need for further legislative restrictions on charitable organizations.[18]

Revenue Act of 1950

In the Revenue Act of 1950,[19] Congress, for the first time, drew significant substantive distinctions between private and public charities through the enactment of the tax on unrelated business income and restrictions on certain financial transactions and income accumulations by selected classes of charitable organizations.

In broad outline, the unrelated business income tax imposed a regular income tax upon the net income derived by certain exempt organizations from the regular conduct of active business enterprises which were unrelated to the organization's exempt purposes. The problems at which the new tax was directed were succinctly summarized in the Report of the House Ways and Means Committee:

> The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these . . . organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemption to buy an ordinary business. That is, they have acquired the business . . . and paid for it in installments out of subsequent earnings – a procedure which usually could not be followed if the business were taxable [H. Rep. No. 2319, 81st Cong., 2d Sess, 36-7 (1950).]

While these purposes would suggest that the unrelated business income tax should apply to all charitable organizations (which it now does), Congress, in 1950, excluded churches and certain other categories of exempt organizations from the tax. In a related measure, Congress also enacted the predecessor to section 502 of the 1954 Code which denies tax-exempt status to so-called "feeder organizations," organizations whose primary purpose is to carry on a trade or business and turn over all of the profits from the business to one or more charitable organizations.

In 1950 Congress was also concerned that abuses of the privilege of tax exemption could result from financial transaction between exempt organizations and donors and other related parties.[20] The Ways and Means Committee concluded that such abuses were particularly prevalent in the cases of charitable trusts and private foundations. It proposed, and the House accepted, a flat prohibition on many such transactions. The Senate expressed "sympathy" for the goals of the House, but concluded that the House solution was too "harsh."[21] A compromise was reached and, as finally enacted, the act contained a section (the predecessor to section 503 of the 1954 Code) styled "prohibited transactions." This provision denied exempt status where a covered organization and a donor, or other related party, engaged in one of the specified transactions at less than arm's-length standards. Among the "prohibited transactions" covered were loans without adequate security and a reasonable rate of interest, payment of compensation except reasonable payments for personal services actually rendered, sales at less than fair market value, and making services available to related parties on a preferential basis.

Because Congress believed that not all charitable organizations had participated in such transactions in an abusive manner, the "prohibited transactions" rules were made applicable only to certain charitable organizations. Excluded from coverage were (1) religious organizations, (2) educational institutions with a regularly enrolled body of students, (3) publicly supported organizations, (4) organizations operated by, or principally supported by, religious organizations, and (5) organizations providing medical or hospital care or medical education or medical research. The reasons for this pattern of coverage were summarized in the Report of the Senate Finance Committee: "The organizations excluded from the application of these provisions are in general what might be called 'public' organizations and because of this characteristic are not believed likely to become involved in any of these prohibited transactions." [S. Rep. No. 2375, 81st Cong., 2nd Sess. 38 (1950).]

Congress, in 1950, was also concerned with the possibility of unreasonable accumulations of income and speculative investments by charitable organizations. As a legislative compromise, the predecessor to section 504 of the 1954 Code was enacted and made applicable to the same organizations as were subject to the prohibited transactions rules. In general, section 504 provided for the revocation of an organization's exempt status where it (1) unreasonably accumulated its income, (2) used its income to a substantial degree for nonexempt purposes, or (3) invested its income in a manner which jeopardized its ability to carry out its exempt purposes.

Finally, Congress in 1950 expanded the annual information return requirements, but again limited the coverage of the reporting requirements to selected charitable organizations.[22]

Internal Revenue Code of 1954

The distinction between "public" and "private" charities, first drawn in a substantial way in 1950, was further broadened in 1954. Earlier, in 1952, Congress had raised the percentage limitations for income tax charitable deductions from 15 to 20 percent of an individual's adjusted gross income. In reaching this decision, the Senate Finance Committee stated:

> Your committee is of the opinion that by increasing the 15 percent limit to 20 percent, much-needed relief will be given to colleges, hospitals, and other organizations who are becoming more and more dependent upon private contributors to enable them to balance their budgets and carry on their programs. The plight in which many of our educational systems find themselves at the present time is due to the fact that their endowment income is inadequate to meet rising costs. It is only through supplemental gifts by the alumni or other persons interested in the cause of education that they are able to continue their programs. Many of the smaller colleges whose alumni have not sufficient means to make adequate contributions are able to continue their existence only through gifts or contributions received by [sic] one or two prominent families in their community. Your Committee believes that it is in the best interest of the country to encourage private contributions to these institutions . . . [S. Rep. No. 1584, 82nd Cong., 2d Sess. 2 (1952).]

In 1954 Congress again sought to encourage charitable contributions by increasing the percentage limitation contained in section 170 of the 1954 Code to 30 percent. However, this additional incentive was made applicable only to religious orders, educational institutions, hospitals, churches, and conventions of churches. Gifts to other charitable organizations, including those now commonly referred to as private foundations, remained subject to the former 20 percent limitation. The committee reports explain the rationale of this amendment in a single sentence: "This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds."[23]

In 1956 the 30 percent category of organizations was expanded to include certain medical research organizations[24] and, in 1962, to include certain state university endowment organizations.[25]

Revenue Act of 1964

In the context of the tax treatment accorded charitable contributions the distinction between private and public charitable organizations was significantly expanded by the three provisions of the Revenue Act of 1964.[26] First, "publicly supported" organizations were added to the list of 30 percent organizations. For this purpose, Congress defined a publicly supported organization as one which normally received a substantial part of its total support from governmental sources or from direct or indirect contributions from the general public. For this purpose, so-called "exempt-function income"[27] was excluded from the definition of public support. Second, contributions to 30 percent organizations which exceeded the 30 percent limitation in one year could be carried over for a period of five years. Third, the so-called "unlimited" charitable deduction was made partly inapplicable to gifts to nonoperating private foundations and other organizations not in the 30 percent category.

The reasons for making these new incentives available to some, but not all, charitable organizations were summarized as follows by the Senate Finance Committee in its discussion of the addition of publicly supported organizations to the 30 percent category:

> The House and your committee agree that the availability of this additional 10-percent deduction should be extended to include contributions to many forms of charitable or philanthropic organizations not now covered by this provision. Greater uniformity in the availability of this additional 10-percent deduction is desirable because of the many beneficial activities that are carried on by various philanthropic organizations not now eligible for the 30-percent deduction. This is especially true of many cultural and educational organizations and major charitable organizations not now eligible for the 30-percent deduction.
>
> The additional 10-percent deduction is limited to organizations which are publicly or governmentally supported, however, and this additional deduction is not made available in the case of private foundations. These latter types of organizations frequently do not make contributions to operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations. [S. Rep. No. 830, 88th Cong., 2d Sess. 58 (1964).]

The Tax Reform Act of 1969

It can be seen from the foregoing that Congress first began distinguishing between classes of exempt charitable organizations in 1943, when a requirement of annual information returns was imposed on selected categories of exempt organizations, and that more significant distinctions resulted from the enactment of the Revenue Act of 1950. In each case, that group of organizations commonly referred to as private foundations was placed in the less favored, or more restricted, class. As pointed out previously, however, the most significant distinctions were drawn by the Congress in 1969. Nearly one third of the Tax Reform Act of 1969 was devoted to provisions affecting exempt organizations and charitable contributions. With few exceptions, private foundations received both disparate and less favorable treatment. As a preface to the discussion of the Tax Reform Act of 1969, reference should be made to a number of studies, investigations, and disclosures which preceded the enactment of the 1969 legislation.

Antecedent Studies

The Walsh Commission. As indicated previously, private foundations were subjected in 1916 to criticism by the Walsh Commission Report.[28] The commission, assigned to investigate the broad area of industrial relations, issued its report after more than two years of hearings. The report concluded that a small group of wealthy families not only controlled the major industries, but also were extending their control over education and "social service," in large part through the creation of "enormous privately managed funds for indefinite purposes," that is, "foundations." The report recommended that all such broad-functioned institutions with over a million dollars in assets be required to obtain a federal charter, which would provide for (1) a limit on the size of a foundation's assets, (2) a mandatory specification of functions and powers, (3) a prohibition against accumulation of unexpended income and a limitation on spending from principal, (4) rigid inspection of investments and expenditures, and (5) open reports to government officials. The chairman and two other members expressed their hostility to the large foundations by appending a suggestion that the Rockefeller Foundation be dissolved.

Cox Committee. Private foundations were subjected to congressional scrutiny in the early 1950s with a view to determining whether they were engaged in "un-American" activities. The House Select Committee to Investigate Foundations and Other Organizations, chaired by Congressman Cox of Georgia, held extensive hearings and issued its final report in 1953.[29] The tone of the report was far from strident and its analysis suggested that foundations had been guilty of little more than errors in judgment. The report noted that foundations' "most significant function has been displayed in supplying the risk or venture capital expended in advancing the frontiers of knowledge"[30] and that the need for foundations to fulfill such a role would increase in the future. As to the charges that prompted the committee's investigation, the report states:

> The committee believes that on balance the record of the foundations is good. It believes that there was infiltration and that judgments were made which, in the light of hindsight, were mistakes, but it also believes that many of these mistakes were made without the knowledge of facts which, while later obtainable, could not have been readily ascertained at the time decisions were taken. It further believes that the foundations are aware of the ever-present danger and are exerting and will continue to exert diligence in averting further mistakes.[31]

The committee noted that the foundations, presently feared as antagonistic to capitalism, were, in the era of the Walsh Report, feared rather as "instruments of vested wealth"; in the opinion of the committee "neither of these fears" was "justified."

On the subject of public disclosure, the committee found that although large foundations viewed themselves as accountable to the public and often published and distributed detailed annual reports, many smaller foundations opposed the public disclosure both of contributions by donors, their families, and related corporations, and, to a lesser extent, of expenditures. The report recommended greater disclosure by foundations of their finances and activities. Under a proposed statutory amendment appended to the report, the annual information return then required of selected charitable organizations, including private foundations, would have been expanded to encompass (1) total year's contributions, (2) amount, general purpose, and recipients of grants, (3) contributors and amounts contributed, and (4) a breakdown of expenses including administrative overhead and salaries, with all but the latter two items to be available to the public. The committee also recommended that the House Ways and Means Committee, rather than it, conduct any studies of tax abuse by private foundations.

Reece Committee. At least in part, because of the time pressures under which the Cox Committee had acted, the House of Representatives appointed a new committee to examine substantially the same subject matter. In its summary of findings, a majority of the Reece Committee described an "interlock" of large private foundations, possessed of enormous influence over social science research and education, and exerting this influence to foster excessive "empiricism," "moral relativity," and leftist and "collectivist" political opinions.[32] The methods of the committee and its staff were challenged as being unfair to the foundations by both a minority of the committee and others.[33] The recommendations of the majority report included a limitation of a foundation's existence of from 10 to 25 years, mandatory distribution by foundations of all of each year's income within 2 to 3 years, a categorical prohibition of all political activity by foundations, and restriction on corporate control of foundations. Recommendations were also made for increased tax audits of the foundations and for consideration by the tax writing committees of the Congress of a variety of alleged problem areas, such as the use of foundations to control businesses.

Patman Investigations. Commencing in 1962, Congressman Wright Patman of Texas undertook an investigation of the impact of private foundations on the American economy. An initial report was issued in December 1962 and Mr. Patman's hearings, investigations, and reports have continued to the present time.[34] Although numerous reform proposals have generated from these investigations, Mr. Patman has been most particularly critical of the use of foundations to control business enterprises and of many of the purposes for which foundation grants have been made. Other commentators have examined the Patman investigations in depth.[35] For purposes of this legal study, Mr. Patman's 1969 testimony before the House Ways and Means Committee[36] contains a sufficiently detailed discussion of the areas of concern generated by the Patman investigations. These areas of concern included (1) the sheer size of private foundations, (2) the use of foundations to perpetuate control of business corporations, (3) grants by private foundations for use outside the United States, (4) influencing political campaigns through voter registration drives and otherwise, (5) grants and other payments to public officials, (6) grants to individuals for questionable purposes and for "esoteric research," (7) use of foundations for private benefit, and (8) questionable investment practices.

Whether or not the examples cited by Mr. Patman were typical of foundations generally, it is beyond reasonable dispute that Mr. Patman's allegations had a significant impact in the development of the provisions of the Tax Reform Act of 1969 relating to private foundations.

Treasury Department Report on Private Foundations. Perhaps due in part to these earlier criticisms of private foundations, the tax-writing committees of the Congress directed the Treasury Department to undertake a comprehensive study of private foundations and to report its findings, together with recommendations for legislative changes. The report was issued in early 1965.[37] Because the Treasury Report had a substantial impact upon the configuration of the private foundation provisions of the Tax Reform Act of 1969, it deserves special mention.

The Treasury Report defined the term "private foundation"—the object of its study—as including organizations described in section 501(c)(3) other than (1) publicly supported organizations, (2) churches and conventions or associations of churches, (3) schools, and (4) organizations that test public safety. Also treated as private foundations for purposes of the report were nonexempt trusts authorized to pay or permanently set aside amounts for charitable purposes. In its study, the Treasury surveyed some 1,300 private foundations.

The Treasury Report concluded that private foundations were an important part of the spectrum of charitable organizations. It stated:

> Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.
>
> Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity. [Treasury Report at 5.]

The Treasury Report also identified three broad criticisms of private foundations made by others, including Congressman Patman. First, that the use of foundations, as opposed to direct contributions by individuals to active charitable organizations, produces an undue delay between the gift generating the tax benefit (that is, the transfer of property to a private foundation) and the use of funds in active charitable persuits. Second, that foundations are becoming a disproportionately large segment of the national economy. Third, that foundations represent dangerous concentrations of social and economic power. To these criticisms, the authors of the Treasury Report made the following response:

> Upon the basis of these contentions, some persons have argued that a time limit should be imposed on the lives of all foundations. Analysis of these criticisms, however, demonstrates that the first appears to be susceptible of solution by a measure of specific design and limited scope, the second lacks factual basis, and the third is, for the present, being amply met by foundations themselves. As a consequence, the Treasury Department has concluded that prompt and effective action to end the specific abuses extant among foundations is preferable to a general limitation upon foundation lives. [Treasury Report at 5.]

In its report the Treasury cited six specific major problem areas and recommended legislative solutions. *First,* the Treasury recommended a proscription on all acts of self-dealing between private foundations and related parties, without regard to whether such transactions were carried on at arm's-length.[38] In this connection, the Treasury Report expressed dissatisfaction with the prohibited transactions rules, described previously, as an enforcement tool because the statute contained too many subjective standards (for example, "reasonable" interest and "adequate" security) and lacked penalties geared to the severity of the violation. *Second,* and responsive to the first general criticism of private foundations noted above, the Treasury recommended that all foundations be required to spend or distribute their income annually and that nonoperating foundations (those that make grants to others rather than conducting activities directly) be required to distribute an amount, whether or not in excess of income, at least equal to a specified percentage of the value of investment assets.[39] *Third*, limitations were proposed on the percentage interest of foundations in corporations and other business enterprises.[40] *Fourth*, the Treasury recommended deferring tax deductions for gifts of property to a private foundation where the donor retained control.[41] *Fifth*, to preclude financial transactions unrelated to exempt purposes, the Treasury recommended prohibiting foundation borrowings for investment purposes, restrictions on loans by foundations, and prohibitions on speculative trading practices and investments.[42] *Sixth*, and in some respects most controversial, the Treasury Report urged legislation to limit family control of foundations by requiring that after the first 25 years of a foundation's existence, the donor and related parties could not constitute more than 25 percent of the foundation's governing body.[43]

The Treasury Report was considered generally to represent a reasoned approach to the private foundation "problem." However, emotion soon overtook the atmosphere and, by 1969, private foundations were viewed by many (including, as noted above, Congressman Patman) as institutions of questionable character. Several factors led to development of this hostile climate. First, public opinion demanded meaningful tax reform and the closing of "loopholes."[44] Second, foundations (and to a lesser extent charitable giving generally) were regarded by many as a "loophole" by which wealthy individuals avoided taxes.[45] Third, foundations were criticized for grants in support of voter registration projects and certain grants to individuals.[46] Finally, a series of disclosures prompted public and legislative concern about the relation of private foundations to the judiciary and to other government employees.[47] Indeed, with respect to this last point, congressional opinion was such that in mid-1969 Senator Williams proposed, and the Senate Finance Committee reported, legislation to deny the tax exemption to any private foundation making payments (with certain narrow exceptions) to any government official or member of his family. The bill was withdrawn on the Senate floor upon the express condition that its subject be considered in the context of the tax reform bill then pending in the House.[48]

These various factors contributed in no small measure to an attitude on the part of many members of Congress which was at best skeptical toward foundations as Congress began consideration of what was to become the Tax Reform Act of 1969.

Peterson Commission. Substantially contemporaneously with congressional consideration of what was to become the Tax Reform Act of 1969, an extensive study was underway in the private sector by the Commission on Foundations and Private Philanthropy. Although the commission did not complete its work and issue a final report until 1970,[49] its chairman, Peter G. Peterson, did appear before the Senate Finance Committee in late 1969 to present several preliminary conclusions that appeared likely to emerge from the commission's studies.[50] Principal of these preliminary conclusions was the need for more reliable information about private foundations and an expression of concern over the quality of foundation investment performance and distribution levels.[51]

The specific recommendations of the Peterson Commission are important and have been discussed elsewhere. For present purposes, however, several of that commission's "findings" are particularly relevant. These include the following:

1. Contributions to foundations are more susceptible of abuse—overvaluation and false claims for gifts never made—than in the case of gifts to other charitable organizations.[52]

2. There is a lack of hard evidence to support claims of widespread financial abuses (for example, self-dealing type transactions) among foundations.[53]

3. Only a minority of foundations owned a controlling block of stock in a business corporation, and most of those who did were larger foundations (assets in excess of $10 million). However, roughly a quarter of the larger foundations held "control stock."[54]

4. Foundation investment performance, using total rate of return on assets as the measurement, was substantially worse than that of mutual funds.[55]

5. In general, foundation grants have been to recognized exempt organizations, rather than to individuals or for purposes that could be considered as involving social or political activism.[56]

An Overview of the 1969 Changes

As a result of the Tax Reform Act of 1969, the distinction between "public" and "private" charities became more pronounced. For purposes of this legal study it is important to note that Congress moved further to encourage gifts to public charities and, implicitly but necessarily, to discourage gifts to private foundations. Simultaneously, Congress enacted a series of statutory restrictions affecting only private foundations. The 1969 act changes, to the extent they involve distinctions between public and private charities, are summarized below.

Charitable contributions. Section 170, the provision of the Internal Revenue Code allowing income tax deductions for charitable contributions, was substantially revised in 1969.[57] The percentage limitation on deductions for gifts to public charities was increased to 50 percent, with two additional classes of organizations being added to the public charity list for this limited purpose. The two additional classes of organizations added are private operating foundations[58] and private foundations which, within one year, distribute all contributions received for active charitable purposes.[59]

Section 170 now contains special rules governing deductions for charitable contributions of appreciated property such as corporate stock.[60] These rules are complex and have been discussed in depth in other studies prepared for the Commission. For present purposes, it is sufficient to note that, generally, such gifts are subject to less stringent limitations when the recipient is a public charity rather than a private one.

Although changes were made in the rules governing the deduction for charitable gifts under the gift and estate tax laws, these changes did not result in the creation of distinctions between private and public charitable organizations.

Tax on investment income. Section 4940 imposes an excise tax, equal to 4 percent of net investment income, upon each private foundation. Thus, private foundations are subject to tax upon their dividends, interest, rents, and royalties, plus capital gains from the sale of property held for the production of such income. Investment income derived by public charities is not subject to tax. Private foundations and public charities alike are subject to the tax on unrelated business income.

Self-dealing. Section 4941 imposes penalty taxes upon each act of self-dealing (as defined) between a private foundation and certain related individuals and entities, termed "disqualified persons" by the statute and including, for this purpose, certain government officials and employees.[61] Subject to certain exceptions and transitional rules the term "self-dealing" includes sales, exchanges, and leasing of property, loans or other extensions of credit, payment of excessive compensation, transfer to or use of foundation assets for the benefit of a disqualified person, and agreements to pay money or other property to government officials. Public charities, in contrast, are subject only to the general prohibition against "private inurement" contained in section 501(c)(3).

Minimum distribution requirements. Section 4942 imposes penalty taxes upon each private foundation that fails to make annual distributions (to prescribed donees) or expenditures for charitable purposes equal to its actual income or, if greater, a specified percentage of the fair market value of the foundation's investment assets. The amount which a private foundation must otherwise distribute under section 4942 is reduced, *pro tanto,* by the amount of the tax imposed by section 4940.[62] This provision, which is not applicable to private operating foundations,[63] is directly responsive to the criticism that use of foundations for charitable giving may often result in an unwarranted delay between the timing of the tax deduction for the gift to charity (the transfer of property to a private foundation) and the actual benefit to charity. Public charities are not subject to any similar requirement.

Excess business holdings. Subject to a myriad of exceptions and transitional rules, section 4943, through the imposition of penalty taxes, prohibits private foundations from retaining more than 20 percent of the voting stock of a corporation, and this percentage is reduced by the percentage of stock held by certain related parties (including commonly created or controlled foundations), termed "disqualified persons" by the statute. No similar limitation applies to public charities.

Speculative investments. Section 4944 imposes penalty taxes upon the speculative investment of the income or assets of a private foundation in a manner that jeopardizes the foundation's ability to carry out its exempt purposes. It represents a continuation of the rule of former section 504, which was repealed by the 1969 act. No comparable restrictions govern the quality of investments by public charities.

Taxable expenditures. Section 4945 imposes penalty taxes upon each "taxable expenditure" by a private foundation. The term "taxable expenditure" includes, with certain narrow exceptions, any amount paid (1) to attempt to influence legislation, (2) to influence an election or to carry on voter registration drives, (3) as a grant to an individual for travel, study or other similar purposes, except pursuant to a procedure approved in advance by the Internal Revenue Service, (4) as a grant to an organization that is not a "public charity" unless "expenditure responsibility" is exercised, and (5) for any purpose other than a charitable or other exempt purpose.

Section 4945 thus imposes substantial restrictions on program activities that are not applicable to charitable organizations generally; and, as to attempts to influence legislation by private foundations, it replaces the test of "substantiality" contained in section 501(c)(3).[64]

Annual reports. Section 6056 requires all private foundations having at least $5,000 in assets, but not other charitable organizations, to prepare and make available for public inspection an annual report of their operations.[65] This requirement is in addition to, and not in lieu of, the annual information return now required to be filed with the Internal Revenue Service by all charitable organizations, other than churches and certain other religious organizations.

While the 1969 act thus broadened the distinctions between public and private charities, it should be noted that in two areas, formerly existing distinctions were eliminated. First, with the exception of churches and other religious organizations and organizations having gross receipts of $5,000 or less, annual information returns are required of all charitable organizations.[66] Second, all charitable organizations, and many other classes of exempt organizations as well, are now subject to the tax on unrelated business income.

Scope of Private Foundation Definition

Given the significant distinctions drawn between public and private charities, it was incumbent upon Congress to define the line of demarcation between the two categories with precision. This line of demarcation is contained in section 509(a),[67] which defines the term "private foundation" as including every section 501(c)(3) organization other than (1) organizations eligible to receive contributions up to 50 percent of an individual's adjusted gross income,[68] (2) organizations that derive at least one third of their total support from specified public sources and receive gross investment income not in excess of one third of their total support, and (3) organizations that are organized and operated for the benefit of one or more specified public charities, are controlled, supervised, or operated by or in connection with such specified public charities, and are not controlled by persons who are disqualified persons (other than foundation managers and the specified public charities) with respect to the organization. The stated rationale for the parameters of the "private foundation" definition is merely that "In general, the problems that gave rise to the statutory provisions of the bill discussed above appear to be especially prevalent in the case of some organizations presently in the 2-percent group. However, it appears that certain other organizations presently in the 20-percent category generally do not give rise to the problems which have led to the restrictions and limitations described above."[69] In amplifcation of this rationale, numerous commentators have made reference to the discipline of public support as an appropriate substitute for legislative controls.[70]

Whatever the rationale, the term "private foundation," as defined in section 509(a),[71] includes all section 501(c)(3) organizations other than

1. Churches or conventions or associations of churches.

2. Educational organizations which normally maintain a regular faculty and curriculum and which normally have a regularly enrolled body of pupils or students in attendance at the place where educational activities are regularly carried on.

3. Organizations whose principal purpose or function is to provide medical or hospital care or medical education or research if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital, but only if the medical research organization is committed to expend for research contributions received within five years of receipt.

4. Organizations functioning as endowment funds, or otherwise administering property, for the benefit of a college or university which is an agency or instrumentality of, or owned and operated by, a State or political subdivision thereof or by an agency or instrumentality of a State or political subdivision thereof.

5. Certain governmental units.

6. Organizations which normally receive a substantial part of their support (exclusive of exempt function income) from governmental units or from direct or

indirect contributions from the general public. (This category includes so-called "community foundations" or "community trusts.")

7. Organizations which
   a. normally receive more than one-third of their total support in each taxable year, subject to specified limitations, from gifts, grants, contributions, membership fees, and exempt function income, *and*
   b. normally receive not more than one-third of their total support in each taxable year from interest, dividends, rents, and royalties.
8. Organizations which are
   a. organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more designated "public charities" described above,
   b. operated, supervised, or controlled by or in connection with the specified "public charities," and
   c. not controlled directly or indirectly by disqualified persons[72] other than foundation managers and the specified public charities.
9. Organizations whose exclusive function is to test for public safety.

As has been indicated, private operating foundations have been distinguished from other private foundations in two significant respects. *First,* operating foundations are not subject to the minimum annual distribution requirements of section 4942. *Second,* the 50 percent limitation on income tax deductions for charitable contributions is applicable. Although the term "operating foundation," as defined in section 4942(j)(3), is somewhat broader,[73] the concept of such organizations was described as follows in the legislative history: "Essentially these are organizations which, although lacking general public support, devote most of their earnings and much of their assets directly to the conduct of their educational, charitable, and religious purposes, as distinct from merely making grants to other organizations for these purposes."[74] The legislative history thus does not explicitly state the rationale for the preferred treatment for operating foundations. Presumably, it was thought that the demands of maintaining a continuing program of activities were sufficient to warrant special incentives for contributions and were an adequate substitute for legislation requiring expenditures for charitable purposes.[75]

II

ANALYSIS OF THE REASONS PROMPTING CURRENT STATUTORY DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITIES

To this point in our analysis, we have simply summarized briefly the historical developments leading to the current pattern of statutory distinctions between public and private charitable organizations. We have shown that at present the federal tax laws distinguish between public and private charities in four significant respects:[76] (1) the tax benefits accorded to individual contributors, (2) the scope of the exemption from tax, (3) the obligation to report directly to the public, and (4) the degree of federal regulation of financial practices and program activities.

The focus of our analysis now shifts from tracing the development of these distinctions to a consideration whether, in each of the four areas noted above, the current statutory distinctions between public and private charities are based upon valid empirical evidence or other sound considerations of federal tax policy.[77]

Deductibility of Contributions

At the present time, both the gift and estate tax provisions of the Internal Revenue Code allow an "unlimited" deduction for charitable contributions and make no distinction based upon the "public" or "private" nature of the donee organization. A much different situation exists with respect to the statutory provision governing income tax deductions for charitable contributions. As pointed out previously, gifts to public charities are subject to a higher percentage limitation and gifts of appreciated property generally are accorded more favorable treatment where the donee is a public charity.

In passing, it should be noted that the resulting complexity of section 170, which now contains three percentage limitations for charitable contributions, has proved to be of such magnitude that the American Bar Association's Section of Taxation has formally recommended that as a matter of public policy, the statute should be completely rewritten to provide for a single 35 percent limitation.[78] A second and perhaps more important side effect of the current pattern of distinctions is that this pattern, perhaps in conjunction with other distinctions against private foundations, apparently has resulted in a decrease in the creation of new private foundations.[79] Given even these two effects, the need to reconsider the wisdom of such distinctions becomes obvious.

The basic rationale of allowing any deduction for charitable gifts has been stated as follows:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. [H. Rep. No. 1860, 75th Cong., 1st Sess. 20 (1938).]

As noted above, Congress first distinguished, for charitable deduction purposes, between classes of charitable organizations in 1954. At that time, Congress merely referred to a desire to aid particular organizations to obtain needed funds to meet rising costs in light of such organizations' relatively low rate of return on endowment funds. In 1954, all of the organizations to which Congress extended favorable treatment were of the type which could reasonably be expected to conduct charitable programs directly rather than merely to provide financial support to others. In 1964, however, this assumption was no longer necessarily true as Congress extended preferential treatment to many publicly supported organizations without regard to whether they were operating or supportive in nature. As noted previously, the stated rationale for not extending such preferential treatment to private foundations was that private foundations "frequently do not make contributions to the operating philanthropic organizations for extended periods of time" and that the purpose of the preferential treatment was "to encourage immediately spendable receipts of contributions for charitable organizations."

From the foregoing, it would appear that the rationale for favored tax treatment for contributions to public charities rests principally on the premise that these organizations either themselves conduct active charitable programs (and thus have both a need for public support and a commitment promptly to expend contributions), or are dependent upon continued public support. It is perhaps the first rationale which prompted Congress in 1969 to expand the list of preferred donees to include "operating" foundations. In our view, this first rationale for the current statutory pattern suffers from two principal defects.

First, there is no assurance that a public charity is in fact an operating rather than a supportive organization. Indeed, numerous organizations, of which community foundations are but one example,[80] that qualify as public charities by reason of the receipt of public support are clearly supportive rather than operating organizations. Moreover, many section 509(a)(3) organizations are supportive organizations.[81]

Second, there is no assurance (much less a legal requirement) that even an operating public charity will in fact immediately expend a donation for the active conduct of its charitable purposes. To illustrate, many gifts to colleges and universities are placed in endowment funds to generate income for future use. This, of course, is the typical case in the gift of property to a nonoperating private foundation. In both cases, there is a delay in benefit to charity and, given the apparent low rate of return on many college endowment funds[82] and the operation of section 4942, the gift to the foundation may in fact (although not necessarily) enter the active charitable stream first. Nevertheless, the two gifts receive different treatment under the current federal tax laws.

It might also be suggested that the current pattern of statutory distinctions can be justified because public charities are dependent upon public support for their continued viability. While this may be true in some cases, dependence upon broad-based public support is expressly required only as to two of the public charity classes.[83] It should be noted, however, that it has been suggested that the current statutory provisions discourage the use of private foundations as a vehicle for charitable giving.[84]

It should also be recognized that the stated rationale for denying preferred treatment to private foundations has rested principally upon the asserted delay in benefits to active charitable pursuits resulting from the use of private foundations as a vehicle for charitable giving. However, with the enactment of section 4942, this rationale for distinction may have lost much of the validity that it may have had as a historical matter.

Based upon the foregoing considerations, and particularly in light of the enactment of section 4942 to prevent unjustified delays in benefit to charity where gifts are made to private foundations, it may be questioned whether, in the area of charitable contributions, the current distinctions between public and private charities are based upon sound considerations of federal tax policy. One could argue that current distinctions can only be justified on the basis of a decision to encourage gifts to certain charitable organizations and not to others. To the extent one accepts the importance of a pluralistic society and the role of all segments of private philanthropy in such a society, the current distinctions become increasingly difficult to justify.

One could, however, take the position that differences in the treatment of charitable contributions can be justified on the ground that "public charities" typically have more broadly based governing bodies than do private foundations and thus may be expected to be more responsive to public needs and less concerned with private preferences or private benefit. It should be noted, however, that this difference, to the extent it in fact exists, has not to date constituted an explicit rationale for the current pattern of distinctions.

Tax on Investment Income

As has been indicated, private foundations, but not other charitable organizations, are subject to a 4 percent tax on net investment income. The imposition of such a tax in 1969 unquestionably marks a significant departure from the well-established policy (described above) of exempting charitable organizations from federal income taxes. An analysis of the legislative history suggests a two-fold rationale for the tax. In its 1969 report, the Ways and Means Committee of the House of Representatives stated:

> Your committee believes that since the benefits of government are available to all, the costs should be borne, at least to some extent, by all of those able to pay. Your committee believes that this is as true for private foundations as it is for taxpayers generally. Also, it is clear that vigorous and extensive administration is needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes. This tax, then, may be viewed as being in part a user fee. [H. Rep. 91-413 (Part I), 91st Cong., 1st Sess. 19 (1969).]

Consistent with this dual rationale, the House of Representatives adopted a 7.5 percent income tax on private foundations. The Treasury recommended that the Senate reduce the rate of tax to 2 percent so as to approximate expected revenues with anticipated costs of enforcement.[85] The Senate agreed that the tax revenues should be limited to the costs of enforcement and, further, cast the tax as an audit fee and based on the fair market value of investment assets.[86] The House-Senate conference returned to the dual rationale of the tax and adopted a 4 percent tax on investment income, casting it as an excise tax measured by income and terming it an "audit fee." As such, the tax was enacted into law.

Meaningful analysis of this dual rationale, and of its application to the distinctions between public and private charities, requires at the outset an examination of the ultimate incidence of the tax. As noted, under section 4942 the distribution requirements imposed upon private foundations are reduced dollar for dollar by the tax on investment income.[87] Consequently, the ultimate burden of the tax does not fall upon private foundations. Rather, it falls upon the organizations and individuals that receive and depend upon foundation support. The net effect of section 4940 is merely to direct private foundations to remit to the federal government a portion of the funds they are otherwise required by law currently to distribute for active charitable purposes. Consequently, private foundations may in some respects be viewed merely as a collecting agent. While the amount received by the federal government from the tax appears to be *de minimis* in comparison with the federal budget, it may be quite significant to at least some of those who must bear the burden of the tax through the receipt of smaller grants, or no grants at all. In this connection, it should be noted that the revenue produced by the tax greatly exceeds the costs of enforcement incurred by the Internal Revenue Service,[88] and that, accordingly, the tax is a general revenue producing measure and not merely an audit fee.

With this understanding of the nature of the tax, a few observations about the rationale for its imposition may be made. First, as noted, as a general revenue producing matter, the revenues produced by tax are minimal and the concept that foundations are sharing in the costs of government is at best "cosmetic." Second, since the burden of the tax is not borne by foundations, the provision represents nothing short of a congressional determination that the needs of government are such that complete tax exemption for charitable organizations is no longer a viable concept. If this is in fact the case, perhaps the question might better be addressed directly, rather than indirectly through the guise of taxing private foundations.[89]

As an "audit fee," the rationale of the tax fails to comport with reality. It raises more than twice the revenue needed to fund the Internal Revenue Service's compliance efforts for the entire exempt organizations field. Moreover, as a matter of tax policy, one may question whether charitable organizations alone ought to assume such a burden. Compliance costs are occasioned by all charitable organizations, and by business leagues, trade associations, labor unions, social welfare organizations and all other exempt organizations. Yet, only private foundations must pay an audit fee. Additionally, under the recently enacted "Employee Retirement Income Security Act of 1974," one half of the tax will be earmarked for a new office of the Internal Revenue Service charged with enforcing not only the exempt organization provisions but the pension law provisions as well.[90] Finally, it should be noted that income is both a unique and questionable measure of an audit or user fee. In light of this purpose, it is at least questionable whether the tax should be measured in some other way, such as by assets.[91]

In summary, one may question whether the rationale of the tax represents sound tax policy. As a general revenue tax, which, at least in part, it clearly is, the tax represents a departure from the long-standing congressional policy of exempting from tax the passive investment income received by charitable organizations. As an audit or user fee, the tax produces too much revenue and is measured by a questionable standard. These considerations would prompt us to conclude that the tax ought to be repealed completely or that, at least, it ought to be cast as a true audit fee, appropriately measured, with revenues limited to actual costs of enforcement. In this connection, it has been noted that foundation support in 1969 and subsequent years for an audit fee was a defensive tactic based on pragmatic rather than philosophical considerations.[92] However, our purpose here is not to examine the tax itself. Rather, our limited purpose is to consider whether, as to the tax, valid distinctions have been made between public and private charities.

As a general revenue tax, the tax, as we have noted, falls upon the potential recipients of foundation grants and the available data suggest that public charities comprise a substantial part of the class of recipients. Given these facts, the first rationale of the tax is somewhat difficult to defend and one might conclude that foundations may have been selected in 1969 because they represented an "easy target." Given the incidence of the tax, it ought to be considered as, at least in part, an indirect tax on public charities raising the basic question of continuing tax exemption.

As an audit fee, it appears difficult to distinguish between public and private charities. While the greater complexity of the foundation provisions may warrant a higher audit fee,[93] there seems to be little or no basis for imposing a fee only with respect to private foundations. Moreover, it is difficult to justify the imposition of an audit fee only upon charitable organizations and not upon other classes of tax-exempt organizations.

Annual Public Reports

As indicated, private foundations, but not other charitable organizations, are required by law to prepare an annual report and make that report available for public inspection. This requirement was added to the 1969 act on the Senate floor at the request of Senator Carl T. Curtis. In soliciting floor support for the amendment, Senator Curtis made the following observations with respect to the rationale for such a requirement:

> [T]he proposed amendment requires annual reports from each and every foundation, to the end that those foundations will act in the public interest, and also so that interested parties, the general public, the Internal Revenue Service, Congress, and the committees concerned will have accurate information . . .
>
> [T]ax exemption is a high privilege. I believe that the operation of a tax exempt foundation is a public trust; and starting from that premise, I believe that all the business, all the transactions, all the receipts, all the investments,

all the grants and contributions made by the foundation to individuals or to institutions, are of public concern.[94]

It is difficult to fault the concept of tax exemption as a public trust which carries with it the obligation of affirmative public accountability. Moreover, it would appear that this concept is equally applicable to all charitable organizations, both public and private. There appears to be no sound basis upon which any charities can or should be excused from public accountability.

While the annual information returns filed by all charitable organizations with the Internal Revenue Service are open to public inspection,[95] these returns are designed (quite properly) to assist the Service in its compliance efforts and to facilitate the Service's data processing needs. As a vehicle for meaningful public disclosure, these returns may in fact be largely meaningless to the public. It might also be argued by some that public reporting is an additional administrative burden that need not and should not be imposed on public charities. Nevertheless, the exemption from tax accorded to a public charity involves no less a public trust than does that accorded a private charity. Finally, an appropriately drafted statutory provision could well alleviate many administrative burdens that might otherwise be encountered.[96]

Restrictions on Financial Practices and Programs

The fourth area of significant distinctions between public and private charitable organizations is found in the provisions of section 4941-4945, enacted in 1969, which impose substantial restrictions on the financial practices and program activities of private foundations. Initially, it should be reemphasized that our focus here is not, for example, upon the rationale for the imposition of any restrictions of self-dealing. Rather, to continue the example, our focus is upon the rationale for imposing self-dealing restrictions upon some but not all charitable organizations.[97]

Restrictions on Self-Dealing

As a result of the 1969 act, private foundations are subject to a flat prohibition on specified financial transactions with substantial contributors and other related parties. Public charities, on the other hand, are not even subject to the arm's-length standards of the prohibited transactions rules first enacted in 1950. They are subject only to the private inurement rules of section 501(c)(3). Undoubtedly, acts now defined as "self-dealing" occurred in the private foundation community prior to 1969.[98] However, questions have been raised as to whether such transactions were a pervasive part of the private foundation field,[99] and there are no data suggesting that similar transactions did not exist in the case of public charities.[100] Moreover, except with respect to transactions involving government officials, the congressional concern over acts of self-dealing appears to have been primarily directed to family controlled foundations.[101] In this connection, it is to be noted that many large private foundations having broadly based governing bodies did not object to the provision or believe that they would be affected by it.[102] The congressional assumption that abuses are more likely to occur in the case of private charities is less difficult to accept in the case of foundations controlled by the donor or other closely related parties. Indeed, the committee reports suggest that the basic rationale of the self-dealing rules was "to avoid the temptation to misuse private foundations for noncharitable purposes" and to substitute a more workable, from an enforcement standpoint, set of standards.[103] As Professor Bittker has stated:

> I am even more skeptical of the implied assumption that the difference between private foundations and other charities is so great (either in the frequency of self-dealing or its resistance to discovery and correction) as to justify a flat prohibition on self-dealing by private foundations, while other charities are not even subject to the pre-1969 prohibitions on self-dealing that favors their contributors and other insiders. On the other hand, this discrimination (as I would regard it) is ordinarily unlikely to impinge seriously on the legitimate activities and social values of private foundations. We may, in short be witnessing a tempest in a teapot.[104]

In the area of self-dealing transactions, the case for such extremely disparate treatment between public and private charitable organizations appears to be based largely on historical precedent and a concern that the documented abuses of a few private charities may be indicative of a broadly based problem. Whether a study of public charities would disclose similar cases of abuse is concededly a matter of speculation. However, Congress has necessarily assumed that it would not. These considerations do not necessarily warrant a suggestion that self-dealing rules applicable to private foundations should be repealed, or that they be applied to public charities as well. One may question, however, whether, as to self-dealing transactions, the gulf between public and private charities is too wide. As a matter of tax policy, self-dealing seems no more or less reprehensible when one type of charitable organization rather than another is involved. Perhaps some middle ground – a set of specific minimum fiduciary standards applicable to all charitable organizations – would be more appropriate.

Minimum Distribution Requirements

Although conceived principally to prevent accumulations of income, a principal feature of section 4942 is the "minimum investment return" concept which, in effect, prevents investments by nonoperating private foundations in low-yield assets except at the cost of current corpus distributions. The apparent rationale for limiting the application of this rule to nonoperating private foundations – if the rationale for exclusion of operating foundatons is a reliable guide – is that, lacking a commitment to an ongoing program, nonoperating private foundations need an external stimulus to assure an adequate level of charitable disbursements. There are, however, two difficulties with this rationale for limited treatment. First, colleges, although desperately in need of funds, have a somewhat questionable record of investment performance and this fact alone causes one to wonder whether the "operations" concept is in fact a valid basis for distinction. Second, there is no assurance that organizations which are excluded by the statute from the scope of section 4942 are in fact operating charities.

A further possible rationale for the limited application of section 4942 may be found in the often used concept of the "discipline" of public support.[105] Under this theory, public charities are deemed to have a constituency which is an effective substitute for external legislative controls. There is, however, little more than supposition either to support or refute this notion. Nevertheless, one might speculate that many small contributors will seldom, if ever, hold the recipient of their contributions to any standard of accountability. Several recent disclosures of excess accumulations and high payments to fund raisers in the public charity field suggest that such speculation may not be completely idle.[106] In this connection, the observations of Professor Bittker warrant special note:

> I know of no hard evidence to support this distinction between the private foundations that are subject to Section 4942 and the charities that are exempt, and indeed am skeptical of the possibility of measuring their comparative propensities to accumulate income without justification. There

> are grant-making private foundations with a strong commitment to programs and objectives, impelling them to use their resources currently rather than postpone the day of distribution. Conversely, there are operating charities and even some publicly supported organizations with programs that are modest in proportion to their assets, so that they are able to accumulate their income with impunity. Even so, the distinction drawn by Section 4942 is persuasive enough to serve as a general principle. Of all the 1969 distinctions between private foundations and other charitable organizations, this one seems to me to rest on the most solid base.[107]

One can certainly conclude that a case can be made for the imposition of legislative controls on distribution levels. Nevertheless, in the absence of further data, one may question whether the present line of demarcation has been properly drawn. Congressional concern in this area might properly extend to all charitable organizations whose function is to provide financial support to others, as opposed to conducting active programs of their own. Yet, under current law, numerous organizations which lack "operating" characteristics have been exempted by the statute. If "operating" versus "nonoperating" is the proper dividing line, the statute has missed its mark.

Excess Business Holdings

The stated rationale of section 4943 is that large holdings in a single corporation may distract the attention of foundation managers from charitable pursuits or promote unfair competition.[108] It has been widely criticized.[109] For present purposes, it is sufficient to note that given the requirements of section 4942 and the basic standards of section 501(c)(3), the statute appears to be justified only if one takes the position that, as a matter of public policy, private foundations should not own a controlling interest in a business enterprise. However, it should be recognized that control of business enterprises has long been a practice of many colleges and schools, and other public charities as well. Seemingly, the "distraction" theory espoused for private foundations in 1969 may also be applicable to public charities.[110]

As a matter of public policy, it may be legitimate to be concerned over retention of corporate control by certain charitable organizations. But concern, if there is any at all, should not be based on the mere fact of corporate ownership, but by the fact of corporate ownership coupled with control of the foundation by donors or others who may have a dual loyalty to the corporation and to philanthropy. Given this hypothesis, the number of organizations to which section 4943 applies appears to be overly broad.

There is an additional dimension to the problem. It has been frequently suggested that, as much of the country's wealth is in corporate stock, section 4943 acts as a disincentive to the creation of new foundations.[111] If this is in fact the case, it may be even more appropriate to consider the question of donor control rather than mere ownership of controlling stock as the factor creating the potential for abuses. Of course, limiting section 4943 to cases involving donor control may do little to eliminate the disincentive apparently resulting from the enactment of section 4943.

Restrictions on Speculative Investments

The legislative history suggests no rationale for the application of section 4944's proscription of speculative investments only to private charities. To our knowledge, there are no data that indicate that private foundations are more or less in need of legislative controls on investment quality than are those of their public charity counterparts which hold property for investment purposes. Moreover, it has been suggested, quite appropriately we believe, that public charities (or at least those which are "operating" rather than "supportive") may in some cases be under greater pressure to produce investment results and thus to engage in questionable investment practices.[112]

There thus appears to be no empirical basis for the distinction between public and private charities in the context of section 4944. Additionally, we discern no public policy reasons which suggest to us a reasonable basis for distinguishing, for this limited purpose, between classes of charitable organizations.

Again, as in the case of the self-dealing rules, the foregoing considerations do not prompt a repeal of the rules concerning speculative investments. One may, however, suggest that as a matter of tax policy, a general set of investment standards may in fact be more appropriate than is the present situation. In this connection, it may be noted that the investment of tax-exempt funds in commodity futures (a form of investment subject to special scrutiny under section 4944) seems no less questionable when made by a public charity.[113]

Restrictions on Program Activities

Section 4945, as noted previously, subjects private foundations to a series of substantive restrictions on program activities. It is clear that section 4945 was a hurried congressional response to several well-publicized instances of questionable activities and was not the product of even the most cursory study to determine whether private foundations, alone among charitable organizations, should be singled out for such restrictions. The rationale for section 4945 seems merely to be that foundations had gotten out of hand and ought to be put back in their place.[114] It is significant to note, however, that the class of foundations that apparently prompted the enactment of section 4945 is not the same as that at which the other restrictions are directed. Indeed, the donor-controlled foundations seem not to have been involved in the "abuses" which led to the enactment of section 4945.

Attempts to influence legislation. The principal distinction between private and public charities with respect to attempts to influence legislation is that private charities are subject to a flat prohibition on such activities (section 4945(d)(1)) while public charities are subject only to the general rule of section 501(c)(3) that "no substantial part" of their activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation. Although there may be practical difficulties with the concept of substantiality,[115] it is difficult to see a valid basis for distinction between public and private charities in the stated reasons for the enactment of section 4945(d)(1). The committee reports merely reflect that Congress believed that foundations had become increasingly involved in legislative activities and that, by reason of the substantiality test, large organizations may "lobby" more than smaller ones. Moreover, it has been suggested that the present pattern of the law in this respect raises problems having a constitutional dimension.[116]

If the often expressed view that it is desirable to have the views and expertise of all with respect to proposed legislation has any vitality, one could then argue that it should be equally applicable to all exempt organizations. Similarly, if attempts to influence public opinion (other than by publication and distribution of nonpartisan research) are suspect, it may be questioned whether they are less so when conducted by a public charity. For these reasons, one may question whether the current pattern of distinctions, as applied in the case of attempts to influence legislation, is based upon valid empirical evidence or sound considerations of federal tax policy.

Influencing elections. Under section 501(c)(3), all charitable organizations are precluded from participating in, or intervening in, any campaign for election to public office. The principal contribution of section 4945(d)(2) is to expressly prohibit foundation support of voter registration drives except under limited conditions designed to assure that such activities are nonpartisan. The few alleged abuses cited in the legislative history appear to have been thought sufficient to support the rationale of the statute. One could conclude, however, that all organizations should be subject to a comparable restriction.

Restriction on grants to individuals and to other private charities. Sections 4945(d)(3) and (4) place restrictions, many of which are procedural, on grants by private foundations to individuals and to other private charities. Assuming for the sake of analysis the wisdom of imposing such restrictions at all,[118] there are no hard data to support the notion that in these two areas of grant making, private charities act less responsibly than their public charity counterparts. Absent such data one can reasonably ask whether it would not be more appropriate to revise the provisions (if they are to be retained at all) to impose minimum standards applicable to supportive organizations generally.

III

FINDINGS AND RECOMMENDATIONS

General Comments

At the outset, we are constrained to voice the view expressed by nearly everyone who has sought to study the field of private philanthropy. There is a paucity of reliable data. Congress felt compelled to take legislative action and yet it had to do so principally on speculation. We have done little better here. For purposes of our analysis, it is particularly important to note the almost total absence of data regarding public charities. While private foundations have at least been examined to some extent, public charities have largely been ignored. Thus, our findings, conclusions, and recommendations lack the support of reliable empirical data. We thus find ourselves in agreement with Professor Bittker's comments when seeking to fathom the current pattern of statutory distinctions by reference to the stated reasons for such distinctions:

> [T]his assessment of the comparative propensity of charitable organizations to engage in activities that are taxed or penalized by the Tax Reform Act of 1969 has been founded – like the legislation itself – more on speculation than on solid evidence. Despite the abundance of congressional hearings and Treasury investigations, the Ninety-first Congress had little more before it than isolated instances of actual, alleged, or suspected misconduct by a few foundations, coupled with a plethora of suggestions that these cases were typical and that existing law 'could' or 'might' or 'probably would' lead to abuses. Even more conjectural was the unarticulated premise that foundations were more likely to succumb to temptation than other charitable organizations. If the need to justify a distinction between private foundations and other charities rose to the conscious level, it was probably satisfied by contrasting the views of the most errant foundations with the reputations of the most scrupulous religious, educational, and publicly supported charities. Yet it is common knowledge that preachers sometimes divert church funds to personal ends, that the nonprofit facade of a school or college can mask a proprietary operation, that some hospitals serve primarily to enrich their physician-entrepreneurs, and that some publicly supported charities allow most of their

> contributions to be siphoned off by grasping fund-raisers. It is equally clear, however, that these instances did not – and should not – impel Congress to extend to the vast body of charitable organizations the labyrinth of statutory restrictions, navigable only by lawyers and accountants and guarded by penalties for deliberate tax fraud, that was prescribed in 1969 for private foundations.
>
> One wonders, therefore, whether it is quixotic to seek an explanation for the 'third-class' status of private foundations, as I have done, in the congressional announcements that accompanied the legislation. Perhaps it would be more realistic to attribute these restrictions to skepticism or distrust of the very characteristics that are often extolled as the virtues of the private foundation – its capacity to experiment because it is usually free of permanent commitments and is controlled by trustees answerable primarily to their own sense of responsibility.[119]

More recently, however, some doubts are being cast upon the implicit rationale of the current pattern of distinctions that abuses have generally not been prevalent in the public charity field. In particular, the hearings held by a subcommittee of the Senate Committee on Labor and Public Welfare[120] and a recent book, *Give*,[121] suggest that a more searching examination of public charities may be necessary.

The Senate subcommittee, chaired by Senator Mondale, directed its attention to the methods of fund raising, amounts spent on fund raising, general management, and program services of children's charities. For present purposes, it is sufficient to note that the testimony received by the subcommittee was often at odds with the common assumption that contributions received by public charities flow swiftly and unerringly to charitable causes. As a result of these hearings, the "discipline of public support" concept to which we have referred seems less attractive. Although *Give. Who Gets Your Charity Dollar?*, may have been written with a "point of view," its assertions, which parallel many of the "disclosures" made during the Mondale hearings, and which raise questions of self-dealing, cannot fairly be ignored.

Clearly, public charities require further study and scrutiny. However, based on the evidence available to date, Senator Mondale has concluded that legislation is needed. To this end, Senator Mondale has proposed a bill to require charitable organizations to spend at least 50 percent of their income on charitable activities.[122]

Thus, despite the paucity of data, one may question whether some of the assumptions made with respect to public charities are in fact valid. Also, it may appear possible to make some tentative findings and suggestions with respect to the current pattern of statutory distinctions between public and private charities.

Areas of Questionable Distinctions

Based upon the data of which we are aware, it may be questioned whether some of the current statutory distinctions between public and private charitable organizations are based upon valid empirical evidence or other sound considerations of federal tax policy. The areas in which we believe such questions may be asked are listed below.

First, with the enactment of the minimum distribution rules in section 4942, and the inordinate complexity of section 170, it may be questioned whether, as to the income tax treatment of charitable contributions, there is any longer any sound basis for distinguishing among classes of charitable organizations. To the extent the present pattern of distinctions reflects a decision to encourage some organizations and, by implication, not others, it may be questioned whether, in a society that ostensibly accepts the values of pluralism and the role of private philanthropy, the decision is a sound one. These questions seem particularly appropriate in the context of the income tax treatment of gifts of appreciated property.

Second, it may be questioned whether there is any sound basis for the imposition of a general revenue income tax on any category of charitable organizations. Moreover, if an "audit fee" is to be imposed on any exempt organizations, a question exists whether it should be limited to a class or certain categories of charitable organizations and, more generally, whether any distinction among exempt organizations both charitable and noncharitable, is appropriate.

Third, there seem to be no significant reasons for distinguishing among classes of charitable organizations with respect to the obligation to report to the public on an annual basis.

Fourth, the reasons prompting a congressional concern with respect to investment practices of private foundations may be equally applicable to charitable organizations generally.

Fifth, as to activities involving legislative matters, the available evidence suggests that "abuses" by private foundations have been greatly overstated, and it may be questioned whether the considerations prompting a more lenient attitude toward public charities are not equally applicable to all charitable organizations.

Sixth, it may be questioned whether the great distinction drawn between public and private charities as to matters of self-dealing is in fact appropriate. Certainly, a case can be made that in donor-controlled organizations, the potential for financial abuse is present, and that, accordingly, a set of objective standards with graduated penalties for violations is necessary. Nevertheless, the question remains whether private charities should be subject to a statute filled with traps for the unwary,[123] while public charities remain virtually exempt from meaningful restrictions.

As a matter of tax policy, consideration of a broadly applied set of objective restrictions may be appropriate. Such an approach would, for example, regard all loans by charitable organizations to private individuals or organizations as equally questionable. Similarly, the making available of services or facilities to related parties on a preferential basis (now prohibited as to private foundations) might be regarded as no less questionable merely because the entity involved is a public charity. Such a statute would have to be drafted with care, but the concept of a generally applicable set of objective fiduciary standards, with more stringent rules for donor-controlled organizations, may deserve careful consideration.

Areas in Which Distinction May Be Appropriate

Our analysis also suggests that, with respect to certain matters, a continuing distinction among classes of charitable organizations may be appropriate as a matter of federal tax policy. The three areas where we believe a basis for distinction may exist are (1) minimum distribution requirements, (2) excess business holdings, and (3) restriction on grants to individuals and to other organizations. Having suggested that some distinctions among classes of charitable organizations may be appropriate. it becomes necessary to consider whether the present line of demarcation between public and private charities is a proper one.

Possible Bases for Distinction

Conceptually, there are a number of ways in which one might distinguish between types of charitable organizations. These include:

Type of organization. One obvious approach would be to merely select certain types of organizations such as churches, hospitals, and schools. This method is currently utilized in the Internal Revenue Code as a part of the technique to distinguish between public and private charities.

Public support. Another approach would be to distinguish among charitable organizations by reference to the degree of dependence upon financial support from the general public. This method is also utilized in the Internal Revenue Code as a part of the technique by which charities are distinguished from private charities. Proponents of this method suggest that the dependence upon public support provides some assurance of operations in the public interest and that this "discipline of public support" is an adequate substitute for legislative restrictions. As noted previously, however, there is little more than speculation to support or refute this theory. Also, use of public support as a criterion may produce curious results where one organization is preferred over another even though both conduct essentially the same activities and are otherwise indistinguishable.[124]

Functional test. A third way in which one might distinguish charitable organizations is by reference to whether the organization's functions involve the active conduct of charitable or other exempt activities or whether, in contrast, the organization merely provides financial support to others who, in turn, actively conduct charitable activities. This concept is employed to some extent in present law to distinguish among private foundations for purposes of section 4942 and the charitable contribution deduction limitations.

Public control. A fourth possible basis of distinction might be premised upon whether the organization is controlled by a governing body broadly representative of the community served by the organization as opposed to a governing body dominated by donors, family members, or other small groups. This test is not currently employed by the Internal Revenue Code to distinguish between public and private charities,[125] although it is considered in the Treasury regulations as a relevant factor under one of the tests for determining whether an organization is publicly supported.[126] This basis for distinction, though little utilized, has some basis in fact since there is evidence tending to suggest that few of the financial "abuses" with which Congress was concerned in 1969 were prevalent in organizations controlled by a broadly based governing body.

Application to Specific Areas

As applied to those areas where a continuing distinction between public and private charities seems appropriate, section 509(a) may be inappropriate as a line of demarcation. In the case of restrictions on excess business holdings, the organizations which appear to possess the potential for abuse seem generally to be those controlled by donors, family members, business associates, or other close groups. In these cases, a distinction based on "public control" may be more suitable even though this would narrow the scope of the application of this provision. Also, if distinctions are to be retained in the self-dealing area, "public control" as a basis for distinction may be more reasonably related to the concerns which prompt the desire to make distinctions.[127]

With respect to the application of section 4942 and the restrictions on grants to individuals and certain other organizations, distinctions based on a functional approach may prove more appropriate. Certainly, public control and public support have little demonstrable connection with the delay in benefits to active charity and the questionable grant-making policies which prompted the enactment of sections 4942, 4945(d)(3), and 4945(d)(4). For example, one might argue that supportive organizations such as community foundations and many section 509(a)(3) organizations should not be excluded from the application of section 4942. On the other hand, it would be quite difficult to justify, on the basis of any reliable data, the application of the excess holdings rules to these organizations.

IV

CONCLUSIONS

In this legal study we have endeavored to develop the current pattern of statutory distinctions between public and private charitable organizations with a view to permitting an informed judgment by the Commission as to whether such distinctions as do exist are based upon valid empirical evidence or other sound considerations of federal tax policy. We have also taken the liberty of suggesting that certain distinctions may be of questionable validity and that others, though perhaps valid, may cover some organizations unnecessarily and exclude others without justification. It should be recognized, however, that such conclusions are necessarily subjective and, by reason of the lack of reliable information, somewhat speculative.

The authors gratefully acknowledge the assistance of Cynthia Blum in the preparation of this paper.

Footnotes

1. Except where otherwise so stated, all statutory citations are to the Internal Revenue Code of 1954, as amended.

2. The exempt purposes specified in section 501(c)(3) are religious, charitable, scientific, testing for public safety, literary, educational, and prevention of cruelty to children or animals.

3. Sections 170 (income tax), 2055 (estate tax), and 2522 (gift tax).

4. To qualify under section 501(c)(3), an organization must be organized and operated exclusively for one or more of the specified exempt purposes, no part of its net earnings may inure to the benefit of any private shareholder or individual, no substantial part of its activities may consist of carrying on propaganda, or otherwise attempting to influence legislation, and it may not participate in, or intervene in, any political campaign on behalf of any candidate for public office.

5. There is a fourth exception (section 509(a)(4)) for organizations which are organized and operated exclusively to test for public safety.

6. Act of August 15, 1894, 28 Stat. 553, c.349.

7. 38 Stat. 11, c.6 (1909).

8. 38 Stat. 114 (1913).

9. 40 Stat. 1057 (1918).

10. 42 Stat. 680 (1921).

11. 48 Stat. 680 (1934).

12. 40 Stat. 300 (1917).

13. Revenue Act of 1935, section 102(c).

14. Public Law 254, title IV, Section 403(a)(3) (1918). Public Law 176, title III, part II, section 321(a)(2) (1924).

15. Revenue Act of 1932, section 505(a)(2).

16. Revenue Act of 1943, section 117. H. Rep. 871, 78th Cong., 1st Sess. 24-25 (1943).

17. Ibid.

18. See Smith and Chiechi, Private Foundations Before and After the Tax Reform Act of 1969, 16 (AEI 1974).

19. 64 Stat. 947 (1950).

20. H. Rep. No. 2319, 81st Cong., 2d Sess. 42 (1950).

21. S. Rep. No. 2375, 81st Cong., 2d Sess. 36-38 (1950).

22. Revenue Act of 1950, section 341. The exclusion of certain organizations appears to have been based principally on the precedent set in 1943.

23. S. Rep. No. 1622, 83rd Cong., 2d Sess. 29 (1954); H. Rep. No. 1337, 83rd Cong., 2d Sess. 25 (1954).

24. Public Law 1022, section [1] (1956).

25. Public Law 87-858, section 2(a) (1962).

26. Public Law 88-272, section 209 (1964).

27. "Exempt function income" includes such items as membership fees, admissions, and receipts from sales or merchandise related to the organization's exempt purposes.

28. Industrial Relations: Final Report and Testimony Submitted to Congress by the Commission on Industrial Relations, S. Doc. No. 415, 64th Cong., 1st Sess. (1916).

29. U.S. Congress, House of Representatives, Final Report of the Select Committee to Investigate Foundations and Other Organizations, H. Rep. No. 2514, 82nd Cong., 2d Sess. (1953).

30. Ibid., at 3.

31. Ibid., at 8.

32. U.S. Congress, House of Representatives, Report of the Special Committee to Investigate Tax-Exempt Foundations and Charitable Organizations, H. Rep. No. 2681, 83rd Cong., 2d Sess. (1954).

33. Ibid., at 421-30. Among the critics were the New York Times, Jacob Javits, then a member of the House of Representatives, and Charles Dollard, President of the Carnegie Corporation. See Lankford, *Congress and the Foundations in the Twentieth Century*, pp. 83-85 (Wisconsin State University - River Falls, 1964).

34. Since enactment of the Tax Reform Act of 1969, Congressman Patman has issued a report on the 15 largest foundations, has proposed additional legislation, and conducted hearings on the operation of the 1969 Act.

35. For an interesting discussion of the origin of the Patman investigations, see Fremont-Smith, Foundations and Government, pp. 365-372 (Russell Sage Foundation, 1965).

36. Hearings on the Subject of Tax Reform before the House Committee on Ways and Means, 91st Cong., 1st Sess. Part 1, 12-78 (1969).

37. U.S. Congress, Senate, U.S. Treasury Department Report on Private Foundations, presented to the Committee on Finance, 89th Cong., 1st Sess. (1965). The Report was published for informational purposes by the House Ways and Means and Senate Finance Committees.

38. Treasury Report at 15-23.

39. Treasury Report at 23-30.

40. Treasury Report at 30-37.

41. Treasury Report at 37-45.

42. Treasury Report at 45-54.

43. Treasury Report at 54-57.

44. A possible "taxpayers' revolt" was suggested by then Secretary of the Treasury Barr in testimony to the House Ways and Means Committee in 1968.

45. Newspaper accounts of a group called "Americans Building Constitutionality," which sought to help middle income taxpayers avoid taxes by establishing private foundations, were given particular prominence.

46. These "questionable" practices were given particular emphasis by Congressman Patman in his 1969 testimony before the Ways and Means Committee.

47. These disclosures included receipt of foundation funds by two Supreme Court Justices.

48. As indicated subsequently, certain government officials and employees are treated as "disqualified persons" for purposes of the self-dealing rules applicable to private foundations.

49. Foundations, Private Giving, and Public Policy, Report and Recommendations of the Commission on Foundations and Private Philanthropy (The University of Chicago Press, (1970). Hereinafter cited as "Peterson Commission Report."

50. Hearings on H.R. 13270 to Reform the Income Tax Laws before the Senate Committee on Finance, 91st Cong., 1st Sess., part 6, 6053-6182 (1969).

51. Responsive to the Peterson Commission's preliminary findings, then proposed section 4942 was amended on the Senate floor to increase the distribution requirements imposed upon private foundations in 1969.

52. Peterson Commission Report at 55.

53. Peterson Commission Report at 56-60.

54. Peterson Commission Report at 72.

55. Peterson Commission Report at 73-76.

56. Peterson Commission Report at 77-86.

57. See Golden, "Charitable Giving in the Seventies: The Impact of the 1969 Act," 48 Taxes 737 (1970).

58. Section 170(b)(1)(A)(vii) and 170(b)(1)(E)(i).

59. Section 170(b)(1)(A)(vii) and 170(b)(1)(E)(ii) and (iii).

60. Section 170(b)(1)(D) and 170(e).

61. The term "disqualified person" is defined in section 4946.

62. Section 4942(d)(2).

63. Section 4942(a)(1).

64. As noted, section 501(c)(3) provides that "no substantial part" of a charitable organization's activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation.

65. The contents of such reports are prescribed by section 6056(b).

66. Section 6033.

67. For a more complete discussion of section 509 by one of the authors, see Moorehead, "Private Foundations and Public Charities: Handling Definitional Problems Under the Tax Reform Act," 31 N.Y.U. Institute on Federal Taxation 1267 (1973).

68. See section 170(b)(1)(A)(i)-(vi).

69. S. Rep. No. 91-552, 91st Cong., 1st Sess. 56 (1969).

70. See, e.g., Halperin, "Private Foundations–Definition and Termination," 29 N.Y.U. Institute on Federal Taxation 1783, 1784 (1971).

71. The pattern of section 509(a) suggests that the provision was influenced at least in part by the earlier statutory distinctions.

72. As noted, the term "disqualified person" is defined in section 4946.

73. See section 4942(j)(3)(B)(ii) and (iii).

74. S. Rep. No. 91-552, 91st Cong., 1st Sess. 60 (1969).

75. Whether this assumption is in fact valid is, to some extent, possibly a matter of speculation.

76. Historically, some distinctions have been made as to excise tax and employment tax matters. However, these areas are not sufficiently important to warrant detailed consideration here.

77. We note at the outset that "sound considerations of Federal tax policy" is necessarily a subjective concept. We also note that a similar analysis has previously been made by Professor Bittker. See note 93, *infra.*

78. This would necessarily reduce the percentage limitation for gifts to public charities.

79. See testimony of John Simon, Hearings Before the Subcommittee on Foundations of the Committee on Finance, 93rd Cong., 1st Sess. (1973).

80. Community foundations, though treated as public charities, are indirectly subjected to some of the private foundation rules under Prop. Treas. Reg. § 1.170A-9(e)(10) *et seq.*

81. The authors understand that many trusts and other organizations which merely provide financial support have qualified under section 509(a)(3) by limiting the beneficiaries to selected designated public charities and according those public charities a degree of participation in the supporting organization's affairs.

82. See Cary and Bright, The Developing Law of Endowment Funds: "The Law and The Lore" Revisited (the Ford Foundation, 1974).

83. Section 170(b)(1)(A)(vi) and 509(a)(2).

84. See note 79, *supra.*

85. This proposal was made in the Treasury's testimony before the Senate Finance Committee in September, 1969.

86. S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969).

87. Section 4942(d)(2).

88. Latest data to be inserted in final report.

89. Labovitz, "1969 Tax Reforms Reconsidered," The Future of Foundations, 101 at 109 (Heimann, ed. 1973).

90. Act, section 1052.

91. In considering ways by which an "audit fee" might be measured, attention should be given the manner in which charges are computed by other agencies, such as the Comptroller of the Currency.

92. See Labovitz, *supra* note 89, at 108-109.

93. See Bittker, "Should Foundations Be Third-Class Charities?" The Future of Foundations, 132 at 146 (Heimann, ed. 1973).

94. Cong. Rec. S15646 (Daily Ed. December 4, 1969).

95. See section 6104.

96. There are a number of "technical" aspects of section 6056 which also deserve clarification to make the contents of such reports more meaningful.

97. For a detailed analysis of the various reasons behind the substantive private foundation rules, see Gregory, "The Congress and Private Foundations – Will the Patient Survive The Operation?" Proceedings, Sixty-Fourth Annual Conference, National Tax Association, 179-206 (1972).

98. See Treasury Report 18-20.

99. See Bittker, note 104, *infra.*

100. The validity of several assumptions respecting public charities is discussed, *infra.*

101. S. Rep. No. 91-552, 91st Cong., 1st Sess. 28-29 (1969). This conclusion does not apply, however, with respect to those self-dealing rules applicable to transactions with government officials.

102. See, e.g., Statement of Alan Pifer, President, Carnegie Corporation of New York, Hearings Before the Committee on Ways and Means, February 18, 1969.

103. See note 101, *supra.*

104. Bittker, *supra* note 93, at 149-150.

105. See note 70, *supra.*

106. These disclosures are noted *infra.*

107. Bittker, *supra* note 93, at 156.

108. S. Rep. No. 91-522, 91st Cong., 1st Sess. 39 (1969).

109. See, e.g., Bittker, *supra* note 93, Gregory, *supra* note 97 and Smith and Chiechi, *supra* note 18.

110. The authors have considerable doubt as to the validity of the distraction theory.

111. This factor was frequently cited in 1969 by those opposed to the enactment of section 4943.

112. Bittker, *supra* note 93, at 155.

113. For other investments subject to special scrutiny, see Treas. Reg. § 53.4944-1(a)(2).

114. S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969).

115. The Ways and Means Committee has recently approved a proposal to substitute, on an elective basis, a mechanical test for determining compliance with the "substantiality" requirement.

116. See Troyer, "Charities, Law-Making, and the Constitution: The Validity of the Restrictions on Influencing Legislation," 31 N.Y.U. Institute on Taxation 1415 (1973).

117. See section 4945(f).

118. Specifically, we question whether, except in the case of grants for charitable purposes to noncharitable organizations, the so-called expenditure responsibility rules accomplish much more than to increase administrative costs incurred by private foundations.

119. Bittker, note 93 *supra*, 159-160.

120. Childrens Charities 1974. Hearings Before the Subcommittee on Children and Youth, Senate Committee on Labor and Public Welfare, 93rd Cong., 2d Sess., Part 1 (1974).

121. Katz, *Give. Who Gets Your Charity Dollar?* (Anchor Press, Doubleday 1974).

122. B.N.A., Daily Report for Executives, No. 209, G-1, (October 29, 1974).

123. See Labovitz, note 89 *supra*, 107-108.

124 For example, some museums with large endowments have been classified as private foundations while others, which were not as fortunate in the past, have been treated as public charities.

125. Use of this basis for distinction would, of course, require a most carefully drafted statute. The 1965 Treasury recommendation on broadening foundation management might serve as a guide should such a distinction be contemplated.

126. See Treas. Reg. § 1.170(a)-9(a)(3).

127. As noted above, we question whether the application of the self-dealing rules should be more broadly based.

THE CHARITABLE DEDUCTION UNDER SECTION 170 OF THE INTERNAL REVENUE CODE

John A. Wallace † and Robert W. Fisher †

Introduction

Contributions of property to qualified charitable organizations have been deductible under federal income tax law since the enactment of the Second Revenue Act of 1917. The original provision allowed a deduction for

> Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 15 per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph.

During the intervening years from 1917 to the present, Congress has enacted amendments to the above provision on 25 separate occasions. As a result, § 170 of the Internal Revenue Code of 1954, as amended, which now controls the income tax charitable deduction, bears little resemblance to the language quoted above.

There is a sharp contrast between the original statute and the present § 170 in terms of sheer size. In addition, the amendments since 1917, which have been accompanied by a similar increase in the volume of interpretive Treasury regulations, have burdened the statute with a degree of complexity that is more than proportional to the change in its length.

This paper will attempt to provide an analytical description of § 170 as presently constituted. The analysis will be directed more to the layman than the scholar, for its purpose is to provide a background for policy decisions concerning the future direction of our tax laws in this area. Thus, precision has at times been sacrificed in favor of a degree of conciseness to provide a workable understanding of the statute as a whole. In addition, emphasis has been placed upon expressed congressional intent and purpose, as well as historical development, where these aspects are particularly helpful in interpretation of the statute.

Original Justification for the Charitable Deduction

The Second Revenue Act of 1917 sharply increased income tax rates to raise the funds needed to finance America's entry into World War I. Congress was understandably concerned that this step might curtail private support of public charities. Proponents of the deduction viewed private donations as coming from the "surplus" of an individual's income, which would be eliminated by the substantial income tax rates about to be imposed. Should the flow of private support dry up, it was argued, these worthy charitable causes would require governmental funds, generated through yet greater taxation.[1] An adaptation of the income tax to encourage continued private support of charity was suggested as an efficient alternative to governmental support.

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Supporters of the charitable deduction also considered that an income tax without a charitable deduction would, in effect, impose a tax upon the charitable organizations themselves. They reasoned that if an individual voluntarily contributed "X" dollars of his income to charity, he would not have the "X" dollars from which to pay the tax on that amount of income; if the donor, aware of this problem, transferred the "X" dollars to charity, less the amount of his anticipated tax on that "X" dollars, the tax would, in effect, be imposed upon the charity.[2]

Finally, congressional supporters of a charitable deduction for income tax purposes felt that an individual should not be taxed on that portion of his income that is devoted to charity.[3] This concept presupposes that the income tax should be imposed only upon consumable income, that is, the income left to the taxpayer following his expenses of earning the income and his contributions to charity.

Each of these original theories is referred to today as a justification for the income tax charitable deduction, but proposals for reform of § 170 differ radically depending upon which theory is emphasized.[4]

Overview of the Statutory Scheme

Today, taxpayers not electing the standard deduction are allowed to deduct all of their gifts to charity. The threshold question controlling the deductibility of a gift to charity, by either a corporate[5] or an individual donor, is whether the gift is a "charitable contribution." This term is defined in § 170(c) as a contribution "to or for the use of" any of several classes of charitable donees.

Assuming that a transfer is charitable, the deduction is nevertheless disallowed if (1) the interest transferred is a partial or split interest that does not meet certain statutory requirements; (2) the donee organization, under certain conditions, terminates its tax-exempt status;[6] (3) the donee organization is a private foundation or a non-exempt trust whose governing instrument fails to prohibit certain types of transactions;[7] or (4) the donee organization has failed to notify the Internal Revenue Service of its application for tax-exempt status.[8]

If a deductible contribution has been made, its value must be determined and the amount of the corresponding deduction, subject to numerous statutory restrictions, must be calculated. At this point, the process frequently becomes quite complex.

The value of a charitable contribution is the "fair market value" of the property contributed, which is defined by the regulations as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[9] While theoretically sound, the application of this standard, particularly in the case of contributions of land, closely held stock, or art objects, is a constant source of friction between taxpayers and the Internal Revenue Service.[10] Further valuation complications arise if the charitable contribution involves a partial or split interest in such property without a readily ascertainable fair market value. Finally, the amount of the contribution may be something less than the fair market value of the property contributed, depending on the character and type of property transferred, the use to which the charitable donee puts the property, the donor's holding period, and whether the property has appreciated while held by the donor.

The size of the deduction is based upon the amount of the contribution. Percentage limitation rules, however, place a ceiling on the deduction allowed in a given year. The applicable percentage limitation depends, in the case of an individual donor, on the classification of the donee organization as either a public or private charity, on whether the contribution of property was "to" or "for the use of" the donee charitable organization, and, since the Tax Reform Act of 1969, on the character and type of property transferred, the donor's holding period, and whether the property has appreciated while held by the donor. Where the amount of the donor's contributions to public charities in a given year exceeds his percentage limitation for that year, the donor is allowed to carry the unused deduction over to subsequent years, subject, of course, to the percentage limitations in such years.

In sum, the deduction for charitable contributions in any given taxable year—which, in turn, represents the extent to which the Internal Revenue Code encourages charitable giving—may depend upon a number of interdependent factors, including the tax status of the donor, the tax status and classification of the donee charitable organization, the type of property contributed and its character in the hands of the donor, whether the property has appreciated while held by the donor, the use to which the charitable donee puts the property, and the mode of transfer employed. It is the interrelationship of these several factors, particularly those which were added or modified by the Tax Reform Act of 1969, that accounts for much of the present complexity of § 170.

I

DEFINITION OF CHARITABLE CONTRIBUTION

The term "charitable contribution" is defined by § 170(c) as a contribution or gift to or for the use of certain listed categories of charitable organizations. The Internal Revenue Service, with the support of recent court decisions, has imposed a gloss on this statutory definition by denying a deduction for contribution to organizations, of the types described in the statute, that engage in activities that are either illegal or against public policy.[11]

For administrative ease, the Service has developed a list of charitable organizations to which contributions will be deemed deductible for income tax purposes. The objective of this published list is to give potential donors advance assurance that their contributions will be deductible. However, because admission to this list has critical practical importance to charitable organizations which seek public support, exclusion from the published list has recently been the subject of heated litigation.

Statutory Definition

The Second Revenue Act of 1917 granted an income tax charitable deduction for contributions or gifts "to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private shareholder or individual." This definition was modified in 1924 to include contributions or gifts "for the use of", as well as "to," these described charities.[12] The list of qualified charitable organizations which are defined in the statute has expanded considerably over the years and now includes the following:

Governmental Units

Under § 170(c)(1), contributions or gifts to certain governmental units are defined as charitable contributions. As noted above, such governmental units were not initially included in the list of qualifying donees. In 1924, the United States, any state, territory, or any political subdivision thereof, and the District of Columbia were added as qualifying donees—provided the contributions were made for exclusively public purposes. Possessions of the United States were added to this list in 1939.

Charitable Corporations, Trusts, Community Chests

As noted above, the list of charitable donees began in 1917 with corporations or associations organized for religious, charitable, scientific, or educational purposes or for the prevention of cruelty to children or animals. This category of organizations was, apart from the inclusion of societies for the prevention of cruelty to children or animals, identical to the category of corporations and associations which were themselves exempt from the income tax as originally enacted in 1913.[13] Generally, changes in this category of donee organizations have been imposed simultaneously with the imposition of identical changes in the comparable class of tax-exempt organizations.[14]

In 1924 the phrase "trust, or community chest, fund, or foundation" was substituted for the term "association," and the purposes for which a qualifying organization could be organized and operated was expanded to include literary pursuits.

The only restriction initially imposed as a condition to the qualification of such an organization was that no part of its net earnings inure to the benefit of any private shareholder or individual. Additional restrictions have since been added. Since 1934, for example, no substantial part of the activities of the organization have been allowed to include the carrying on of propaganda or otherwise attempting to influence legislation. Also, since 1935 with respect to contributions by corporations and 1938 with respect to contributions by individuals, this category has been restricted to "domestic" organizations.[15] A further restriction, applicable only to *corporate* donors, was imposed in 1954 to limit the qualification of charitable contributions to such organizations to those contributions that are for use within the United States or a possession.

Posts or Organizations of War Veterans

Since 1924 for individual contributions and 1943 for corporate contributions, posts or organizations of war veterans (and certain ancillary organizations) have been included in the list of qualifying donees.

While posts or organizations of war veterans must be organized in the United States or its possessions, and no part of their net earnings may inure to the benefit of any private shareholder or individual, in all other ways, this category is less restrictive than the category of charitable corporations, trusts, or community chests, and so forth. Thus, a post or organization of war veterans need not be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals; there is no requirement that it avoid lobbying and propagandizing activities, and its contributions may be used abroad.

Domestic Fraternal Societies, Orders, or Associations Operated Under the Lodge System

This category of charitable donee organizations was added in 1924, and only contributions to such organizations *by individuals* qualify as charitable contributions. This organizational category is also less restrictive than the general category of charitable corporations, trusts, community chests since the restrictions against private inurement and lobbying are not imposed and contributions may be used outside the United States and its possessions.

Cemetery Companies

In 1954, cemetery companies and other corporations chartered solely for burial purposes were added to the list of charitable donee organizations.

Amounts Paid To Maintain Certain Students as Members of Taxpayer's Household

In 1960 the statute was amended to treat amounts paid to maintain certain students as members of the taxpayer's household, subject to certain limitations, as paid for the use of the educational institution and, thus, as charitable contributions.[16]

Although the status of a qualified charitable organization is determined by these provisions, the statutory language is necessarily broad and in many instances leaves much room for interpretation by taxpayers, the Internal Revenue Service, and the courts. Perhaps the broadest definitional problems are posed by the issues of whether an organization is organized exclusively for "charitable" purposes or whether that organization is a "religious" organization. Answers to such questions obviously depend upon ever-changing social conditions and attitudes and will never be fully resolved by statutory analysis alone.[17]

Publication 78

Since the issue of whether a contribution is deductible under § 170 turns on the character and activities of the recipient donee organization, the Internal Revenue Service has devised a system to give donors advance notice of which organizations qualify.

When a charitable organization receives a ruling confirming its tax-exempt status, the ruling also states that contributions to it are deductible by donors. The names of these approved organizations are compiled and published by the Service in Publication 78.

The Service has announced that, with limited exceptions, a donor may rely on Publication 78 so long as the subject donee organization retains its listing.[18] If a material change occurs in the character or activities of an organization listed in Publication 78, the ruling letter acknowledging the deductibility of its contributions immediately ceases to apply.[19] The Service has ruled, however, that donors will continue to be allowed deductions for contributions made after the organization ceases to qualify but before the organization loses its listing in Publication 78, except where the donor

1. had knowledge of the revocation of the ruling or determination letter,
2. was aware that such revocation was iminent, or
3. was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of qualification.[20]

This procedure, however, applies *only* to organizations listed in Publication 78. Where the ruling or determination letter of a non-listed organization has ceased to be applicable because of a change in its character or activities, donations made after the change has occurred are not deductible. Donors, therefore, may reasonably be reluctant to make contributions to non-listed donees with determination letters or rulings.[21] Thus, a listing in Publication 78 is critical to charitable organizations seeking public support.[22]

Because of the seriousness of a revocation and removal from Publication 78, the Service has prescribed procedures for immediate protest by the donee organization and review by the IRS District Director and the National Office whenever such action is considered.[23]

II

PARTIAL AND SPLIT-INTEREST TRANSFERS

Over the years, donors have frequently transferred income and remainder interests in trust to charity. The popularity of this technique may be attributed, at least in part, to the fact that the donor receives a current income tax deduction for the value of the interest given to the charity while retaining for himself or his dependents either a present or a future interest in the transferred property. Congressional approval for this method of charitable giving in the years prior to 1969 may be inferred from the fact that, with one exception, no statutory limitation was imposed upon charitable transfers in trust until 1969, when the rules governing deductions for charitable contributions in trust were substantially revised. The exception, presently found in § 170(a)(3), applies only to contributions of future interests in tangible personal property and treats such contributions as made only when all intervening interests and rights to actual possession or enjoyment of the property expire or are held by persons other than the donor or related persons.

The new rules added by the Tax Reform Act of 1969 disallow the deduction for a contribution of a remainder interest in trust unless the trust takes one of three statutorily prescribed forms. Comparable rules for transfers of income interests in trust to charity were also enacted. Finally, to prevent avoidance of these new rules by the use of legal life estates and remainders, the Tax Reform Act imposed similar restrictions upon outright transfers of partial interests in property to charity.[24]

Remainder Interests in Trust

Many donors are willing to make substantial contributions to charity if they are permitted to reserve a life interest in the transferred property for themselves or their dependents. Often, the ability to retain the income from, or the use of, the property enables a donor to make a charitable contribution that he could not otherwise afford. Section 170 allows the donor an immediate deduction for the remainder interest irrevocably designated for charity, computed by discounting the remainder interest to a present value through the use of published actuarial tables, based upon an assumed rate of investment return. This discount theoretically eliminates any advantage to the donor arising from the time differential between the date the trust is created and the date the charity actually receives its interest.

By 1969 the Treasury was concerned that the value of the benefits actually received by the charitable donee of a trust remainder interest often did not correlate with the value assigned to the transferred interest at the time the charitable deduction was calculated. In part, this discrepancy resulted from the use of actuarial tables based upon an assumed 3.5 percent rate of investment return which obviously did not reflect the investment yields or interest rates prevalent in 1969. Also, donors could exploit existing valuation procedures by transferring high-yield securities with limited growth potential into charitable remainder trusts. Finally, donors were permitted to establish charitable remainder trusts with powers of invasion for the benefit of the noncharitable income beneficiary and still receive a deduction for the full value of the remainder interest. While the power of invasion had to be limited by an ascertainable standard, there was obviously a distinct possibility in any case that the standard for invasion could be met and trust corpus otherwise directed to charity paid out to the noncharitable beneficiary.

The stated congressional purpose for imposing new rules upon charitable contributions in trust in 1969 was to eliminate, insofar as possible, any possible discrepancy between the discounted value upon which the donor's tax deduction was based and the value of the property actually received by charity.[25] The new statutory trust forms, the qualified charitable remainder annuity trust, unitrust and pooled income fund, are designed to correlate the payment of benefits to achieve this objective.

Thus, in order to qualify as a charitable remainder annuity trust, the trust agreement must require the trustee to distribute annually a specified sum (not less than 5 percent of the initial net fair market value of the property placed in the trust) to one or more persons (at least one of which is not a charitable organization) living at the time the trust is created. In addition, the term over which such payments are made may not exceed the life or lives of the noncharitable beneficiaries or the period of 20 years if the payment is to be made over a stated period of time, and the remainder interest must be transferred to or for the use of charity.[26]

A qualified charitable remainder unitrust must meet the identical requirements set out for the charitable remainder annuity trust, except that the annual payment to the noncharitable beneficiary must be a fixed percentage (which is not less than 5 percent of the net fair market value of the trust assets each year), rather than a sum certain.[27]

A pooled income fund is a trust maintained by the charitable organization to which the donor transfers the remainder interest. In the case of property transfers to this entity, the donor must retain an income interest for the life of one or more beneficiaries (all of whom must be living at the time of the transfer), and the remainder interest in the property must be irrevocably contributed to or for the use of the donee charity.[28] The pooled income fund is unique because the property transferred to the fund by each donor is commingled and invested with the property transferred to the fund by all other donors. The income interest retained by, and paid to, the donor or his designated beneficiary or beneficiaries is the income actually earned by the fund each year. The calculation of the deduction for the donor is also based upon the actual income yield of the fund determined on an experience basis, although a 6 percent yield is presumed if the fund has not been in existence for at least 3 years prior to the transfer.

A qualified charitable remainder trust form may be employed by any donor who wishes to make a transfer of a remainder interest in trust to charity, but the use of the pooled income fund arrangement depends upon the willingness of a chosen charity to maintain a fund of this type. Until public charities have an opportunity to consider and establish pooled income funds for prospective donors, their scope will be somewhat limited.

The requirement that the transfer of a charitable remainder interest take one of these prescribed forms was thought to provide a means of insuring that the amount received by the charity would correspond with the amount of the charitable deduction allowed to the donor at the time the trust is created.[29] This requirement does not apply, however, where all of the donor's interest in the property is contributed to charity, or where the remainder interest contributed constitutes the donor's entire interest in the property.

Finally, the statutory restrictions imposed upon transfers of charitable remainder interests in 1969 included the further requirement that straight line depreciation and cost depletion be used to determine the value of contributions of remainder interests in real property.[30]

The Treasury also issued new valuation tables in 1969, which were based upon a 6 percent annual rate of return, in conjunction with these statutory restrictions.[31] In addition, separate actuarial tables were published for male and female lives to reflect the fact that females have a longer life expectancy. The new tables obviously curtail the tax incentive for transfers of remainder interests since they increase the value of the life estate and reduce the value of the remainder and the corresponding deduction. For example, the value of a remainder interest following a trust term of 20 years was slightly more that 50 percent of the value of the property transferred to the trust under the old 3.5 percent tables; the new 6 percent tables reduce the deductible interest to 30 percent of the value of that property.

Income Interests in Trust

As indicated, in 1969 the rules governing the income tax deduction for charitable contributions of income interests in trust were also substantially revised. To a large extent these revisions parallel the rules governing the deductibility of contributions of remainder interests to charity. Thus, § 170(f)(2)(B) now requires that the income interest transferred to charity must be payable in the form of a guaranteed annuity or a fixed percentage, calculated annually, of the fair market value of the trust property involved, in order to equate the value of the interest given to charity with the amount of the donor's deduction.

However, Congress imposed a second condition on the allowance of a charitable deduction for the transfer of an income interest in trust in 1969, namely, that the donor must be treated as the owner of the transferred property under the grantor trust rules.[32] In effect, a donor will receive an immediate deduction for the value of an income interest transferred to charity after 1969 only if he is taxed on the income as it is earned and paid over to the charity in subsequent years. This additional restriction was designed to eliminate what Congress perceived to be an unnecessary tax break for transfers of income interests in trust to charity under prior law. The break arises from the fact that the deduction is attributable to property that consists entirely of future untaxed income, as opposed to the contribution of a remainder interest in property which was presumably acquired by the donor with previously taxed funds.

This rule does not deny the donor any benefit from the timing differential, however, since the entire actuarial value of the income interest is immediately deductible, while the receipt of taxable income is spread out over a number of years in the future. As in the case of charitable remainders, the benefit from this timing differential is theoretically removed by discounting the amount of the contribution to its present value.[33] If tax-exempt securities are transferred, the requirement that future income earned from the property be taxed to the grantor may not have an adverse tax impact. Also, if the donor transfers the income interest in a year when he has an unusually high income, the tax bracket differential between the year of transfer and subsequent years may soften the tax effect of this new rule.

To guard against the possibility that a grantor might obtain a charitable deduction as a result of being currently taxed on the income and, once the statute of limitations has run on the year of the deduction, arrange to avoid the grantor trust rules, § 170(b)(2)(B) provides a recapture rule.[34] Once the donor ceases to be taxable on the trust income, he is treated as having received taxable income to the extent of the deduction previously allowed less the discounted value of all amounts earned by the trust which were actually paid to charity and taxed to the donor before he ceased to be taxed on the income under the grantor trust rules. These recapture rules ignore any difference in tax brackets between the year of deduction and the year of recapture.

As is the case with contributions of remainder interests in trust, the restrictions in § 170(f)(2) do not apply where all interests in the property are contributed to charity or where the income interest contributed is the donor's entire interest in the property.[35] Thus, not only is the requirement as to the form of the income interest waived, as it is in the case of contributions of remainder interests, but the requirement that the donor be taxed on the income is also waived. It is unclear why congressional concern over excessive tax benefits to donors did not extend to transfers of life estates in this context.

Transfers of Partial Interests

Rules limiting the deductibility of transfers of partial interests in property, other than in trust, were also imposed in 1969. Section 170(f)(3) denies a charitable deduction in the case of contributions of partial interests in property unless a deduction would have been allowed under the trust rules described above, assuming the interest had been transferred in trust. This provision protects the integrity of the split interest trust rules of § 170(f)(2), which might otherwise be avoided by transfers of legal, rather than equitable, life estates and remainder interests to charity. In the case of a remainder interest, therefore, a deduction is allowed only if the charity's interest resembles a qualified charitable remainder annuity trust or unitrust. A deduction for a contribution of an income interest is allowed only if the life estate is substantially analogous to either a guaranteed annuity or a unitrust and the grantor is taxed on the income as it is earned.

In conformity with the rules affecting partial interests transferred in trust, these requirements do not apply where the partial interest contributed is the donor's entire interest in the property[36] or where all interests in the property are contributed to charity.[37]

Two additional exceptions to the imposition of the strict trust requirements on contributions of partial interests should be mentioned. Under § 170(f)(3)(B), a charitable contribution of an undivided portion of the donor's entire interest in property is deductible. To qualify under this exception, the interest contributed must consist of a fraction of each and every substantial interest or right owned by the donor in the property and must extend over the entire term of the donor's interest.[38] For example, a donor is allowed a deduction where he gives to charity the right, as a tenant-in-common with him, to possession and control of the property. Similarly, if the donor merely owns a partial interest in the property, such as a life estate or a remainder, he will be permitted a charitable deduction if he transfers an undivided portion of his entire partial interest in the charity. A liberal construction has been afforded the language "undivided interest" so as to include open-space easements.[39]

Another exception is provided for transfers of remainder interests in personal residences (which the regulations indicate need not be a taxpayer's principal residence[40]) and farms. This exception arose at the instance of the Senate Finance Committee which amended the House Bill to allow a charitable contribution deduction for the gift of remainder interests in real property to charity. The committee cited the example of a contribution of a personal residence and stated that such situations generally do not present the kind of abuse that the limitations on partial contributions were intended to curtail. The committee conceded that a limited valuation problem might exist, but felt that this problem could be dealt with in a less onerous fashion. Thus, as in the case of a contribution of a remainder interest in real property in trust, the committee provided that in determining the value of a charitable remainder interest in real property, straight line depreciation and cost depletion be taken into account and that such value be discounted at a rate of 6 percent (or such rate as the Secretary or his delegate may prescribe).[41]

The Conference Committee, however, while adopting the valuation provisions, limited the exception for remainder interests to remainder interests in personal residences and farms.

III

AMOUNT OF CONTRIBUTIONS: APPRECIATED PROPERTY RULES

The amount of a charitable contribution is generally deemed to be the value of the property contributed.[42] When applied to a gift of property which has a fair market value in excess of its tax basis ("appreciated property"), this rule results in the allowance of a charitable deduction for unrealized gain. Since a gift of property to charity is generally not considered to be a taxable event, the donor avoids the recognition of gain on the appreciation element in the property and receives a charitable deduction based upon its full value.[43]

This double tax benefit is particularly attractive if the appreciation element would otherwise have been taxed as ordinary income. For instance, prior to 1969 donors holding § 306 stock, stock in a collapsible corporation, or inventory could frequently donate the property to charity and be economically better off than they would have been had they sold the stock, been taxed at ordinary income rates on the appreciation element, and retained the net proceeds for themselves.

Development of Reduction Rules

In 1938 the House Ways and Means Committee, concerned about the appreciated property problem, proposed an amendment to the tax law which would have set a blanket rule that "in the case of a contribution or gift made in property other than money the allowable deduction shall be limited to the adjusted basis of the property . . . in the hands of the donor or the fair market value of the property at the time of the contribution or gift, whichever is the lower."[44] The Senate Finance Committee, however, rejected this amendment, citing its concern that the change would unduly discourage transfers of charitable gifts in kind.[45] Following defeat of this proposal, Congress did not again address the appreciated property problem, at least in a comprehensive sense, until the Tax Reform Act of 1969.

In the interim, however, several exceptions to the general rule that the amount of the contribution equals the fair market value of the contributed property did emerge. Simultaneously with the introduction of the § 1245 depreciation recapture rules in The Revenue Act of 1962, § 170 was amended to provide that in the case of a contribution of § 1245 property, the amount of the contribution would be the value of that property less the amount treated as gain to which § 1245 would have applied if the property had instead been sold by the donor at its fair market value. Again, in 1964, when Congress enacted an additional depreciation recapture provision, § 1250, a corresponding amendment was added to § 170 to eliminate avoidance of the new recapture rule through a charitable contribution of the subject property. A third recapture rule, this time dealing with the disposition of certain mining property, was added by § 617 in 1966. Congress again enacted a change to § 170 to reduce the value of any charitable contribution of mining property by the mount that would have been subject to recapture under § 617.

These interim amendments to § 170 were clearly ancillary to the imposition of ew recapture rules for accelerated depreciation and certain mining exploration eductions. As such, they did not reflect a direct reform effort by Congress to deal ith the appreciated property aspects of the income tax charitable deduction. These amendments did, however, indicate a congressional awareness of the importance of the relationship between the tax consequences governing a taxable disposition and a charitable disposition of property.

In the Tax Reform Act of 1969, Congress dealt directly with the appreciated property issue in § 170.[46] A number of changes were enacted to dilute the tax incentives previously afforded donors transferring appreciated property in kind to charity. While these changes hit hardest at contributions of appreciated property that would cause an ordinary income tax liability if sold, the attack on the appreciated property problem took several fronts.

First, the value of any property contributed to charity is reduced by the amount of gain that would not have been long term capital gain if the property had been sold by the donor ("ordinary income property").[47] In effect, this rule limits the donor's deduction to the adjusted tax basis of ordinary income property, such as § 306 stock, inventory, and self-made works of art.

Second, the value of any tangible personal property given to charity, if the use by the donee is unrelated to the purpose or function constituting the basis for the donee organization's exemption under § 501, is reduced by 50 percent of the amount of gain that would have been long term capital gain if the property contributed had been sold by the donor at its fair market value ("capital gain property").[48] An example of a gift of this type would be the donation of a valuable painting to a hospital which expected to sell the painting and use the proceeds in a current construction program.

Third, the value of any property contributed to or for the use of a private foundation, other than a private foundation that passes the property on through to a public charity shortly after receipt, is reduced by 50 percent of the amount of gain that would have been long term capital gain if the property contributed had been sold by the donor at its fair market value.[49]

Fourth, an election is provided for gifts of appreciated property to public charities whereby a donor may increase the applicable percentage limitation from the 30 percent limitation, generally applicable to gifts of appreciated property, to the 50 percent limitation, by subjecting all gifts of appreciated property that year to the 50 percent reduction rule.[50] This provision will be discussed in greater detail below.

There can be no doubt that these new rules, where applicable, generally achieve the statutory purpose of placing the donor in roughly the same position as if the appreciated property in question were sold and the cash proceeds instead contributed to the charity. In the case of a contribution of appreciated capital gain property to a private foundation, for example, the reduction of the deduction amount to the donor's cost basis plus 50 percent of the appreciation element (that portion of the appreciation subject to the § 1202 deduction in the case of a sale or exchange) produces a net tax result identical to a sale or exchange of the property subject to the new rules. While the objective of the reduction rules is easily stated and they work well in most instances, there are several noteworthy problem areas.

Contributions of Ordinary Income Property

Some uncertainty exists regarding the application of the ordinary income property reduction rule to § 1231 property, which is property used in the donor's trade or business. Section 170(e)(1) expressly provides that

> For the purpose of applying this paragraph (other than in the case of gain to which Section 617(d)(1), 1245(a), 1250(a), 1251(c), or 1252(a) applies), property which is property used in the trade or business (as defined in Section 1231(b)) shall be treated as a capital asset.

The purpose of this provision is to eliminate the necessity of analyzing all other § 1231 transactions during the year to determine whether the contributed asset, if sold, would give rise to capital gain or ordinary income in that year; any other approach would create uncertainty for a potential donor because this determination cannot normally be made until the end of the taxable year. As a result, § 1231 assets are treated as capital gain property and are not subject to the ordinary income property reduction rule.

Where a portion of the gain on a § 1231 asset would be taxed as ordinary income, as under § 1245 for example, the proper application of the quoted provision of § 170(e)(1) is unclear. In light of its purpose, which is to eliminate the necessity of analyzing all the year's § 1231 transactions to determine the amount of the contribution, the parenthetical should be construed to read: "Except to the extent of gain to which 617(d)(1), 1245(a), 1250(a), 1251(c), or 1252(a) applies." This is, in fact, the approach adopted by the regulations.[51]

With respect to § 1231 assets, it should be noted that the purpose of the reduction rules, that is, placing the donor of appreciated property in roughly the same position he would occupy if the appreciated property were sold and the proceeds contributed, is not completely achieved. Where the sale of a § 1231 asset would result in ordinary income because of § 1231 losses in excess of potential gain, the donor is better off if he contributes the asset itself than if he contributes the cash proceeds from the sale of the asset. By contributing the property, the donor obtains a full charitable deduction, and other § 1231 losses are not offset by the gain that would have been realized on a sale of the asset.

Contributions of Unrelated Use Tangible Personal Property

The new reduction rules for appreciated tangible personal capital gain property make the use of that property by the donee charity pivotal to the donor's tax result.

It has been suggested by one commentator[52] that relevant legislative history indicates that actual use of the property by the charity is not sufficient; rather, the use must be directly connected with the charity's exempt function. Under this approach, a painting with a secular theme given to a church to be hung in its administrative offices, for example, would not be related-use property, while a religious painting given to a church for its library might be related-use property. The regulations, however, take a more sensible approach, stating:

> If furnishings contributed to a charitable organization are used by it in its offices and buildings in the course of carrying out its functions, the use of the property is not unrelated use.[53]

In fact, the only example provided by the regulations of an unrelated use involves a sale of the property by the charity. Thus, under the regulations it is arguable that any actual use by the donee charity (other than sale) qualifies as a related use.[54] Presumably, any use by the charity merely to generate income, whether or not the income is in turn used for exempt purposes, will be treated as an unrelated use by analogy to a sale.

The regulations attempt to distinguish related from unrelated use by defining "unrelated use" and treating everything else as a "related use."[55] Typically, the examples in the regulations deal with situations where the use of the property involved is easily established and, therefore, are not of universal help.

While the regulations place the burden upon the donor to establish that the property involved is put to a related use by the donee charity, barring actual knowledge of an intended unrelated use, the donor is permitted to carry that burden by showing that at the time of transfer it was reasonable to anticipate that the property would be retained and used by the donee charity in a manner related to its exempt function. This test permits the donor to rely upon a reasonable expectation of what the donee charity would normally be inclined to do with the property gift, absent any express understanding to the contrary, and should obviate the need for donors to require detailed and restrictive covenants from the donee charity as a part of the transaction.

Despite the liberal approach taken by the regulations in this area, the unrelated-use rule can still produce harsh results in given cases. If, for example, a donor contributes a Rembrandt to a museum with the understanding that the museum, which already has an adequate collection of Rembrandts, intends to exchange it for a Goya as soon as the opportunity arises, the Rembrandt would be unrelated-use property. In this case the donor should wait, if possible, until he is able to exchange the Rembrandt for a Goya, tax free in a like kind exchange under § 1031, and contribute the Goya as related-use property.

There is also some uncertainty about the application of the tangible personal property reduction rule where a remainder interest in such property is transferred, in trust or otherwise. Section 170(a)(3) requires that contributions of future interests in tangible personal property be treated as made only when all intervening interests in and rights to actual possession or enjoyment of the property have expired or are held by persons other than the donor or unrelated persons. In those instances where an interest is retained by the donor or related parties and the calculation of the deduction must be delayed until the intervening interests expire, the related-use test will be applied at the time the charity actually takes the property, when the facts are easily discerned.

On the other hand, if all intervening interests are held by the persons unrelated to the donor, an immediate deduction is allowed and the impact of the reduction rule must be determined in advance of the charity's receipt of the property. This raises the issue of whether the absence of an immediate "use by the donee" requires an automatic reduction, or whether the test is satisfied by the anticipated property use. Although at least one commentator disagrees,[56] it is difficult to justify an automatic reduction in this circumstance. Otherwise, the rule would rather anomalously favor the contribution of a future interest where the intervening interest is held by the donor or a person related to him over the contribution of a future interest where the intervening interest is held by an unrelated party. Also, an anticipated-use standard is consistent with the general approach adopted in the regulations of testing the reasonable expectations of the donor rather than actual use by the donee.

Other Problems

Until the regulations under § 170(e) were published, the operation of the reduction rules in transactions where the gift of property is an event requiring immediate recognition of gain caused apparent problems. The contribution of an installment obligation presents such an instance because § 453 deems the charitable transfer a disposition which causes the deferred income element to be taxed immediately to the donor.[57] Other examples include a transfer of property resulting in an anticipatory assignment of income, a transfer of an obligation issued at a discount, or a transfer of stock purchased pursuant to a qualified option within three years of the exercise of the option. Under a strict application of the reduction rules, the donor of such property is allowed no deduction for the amount of gain on which he is currently taxed. This result places the donor in a worse position than if he had sold the property and contributed the cash proceeds to charity.

The regulations resolve this problem, in the face of rather unaccomodating statutory language (and tacit recognition of the problem during the formulation of the provision),[58] by excepting the application of the reduction rules "where, by reason of the transfer of the contributed property, ordinary income or capital gain is recognized by the donor in the same taxable year in which the contribution is made."[59] This exception appears reasonable in light of the policy underlying the reduction rules of reducing the value of appreciated property transfers only where the donor would otherwise escape tax on the appreciation element.

The issue of whether the reduction rules are applicable to transfers of income or remainder interests in trust to charity and, if so, how the rules operate in this context, is particularly troublesome.

There is little doubt from the literal language of § 170(e), the regulations,[60] and the scant legislative history which deals with this question[61] that the reduction rules apply to transfers of remainder interests in trust. Assuming the reduction rules apply to such transfers, the next question is whether the property interest given to charity is the interest in the trust or the underlying trust assets. A remainder interest in a trust may well qualify as a capital asset even if the property in the trust is ordinary income property, such as inventory, in the hands of the grantor. Similarly, a remainder interest in trust is an intangible asset even if the property in the trust is tangible property.

Since the reduction rules operate differently upon ordinary income and capital gain property and, in certain instances, upon tangible and intangible property, the determination of the character of the property transferred to charity in this context markedly affects the ultimate tax consequences of the transaction. If a donor makes a qualifying contribution of a remainder interest in an appreciated asset in trust to a charity, retaining an income interest, the purpose of the reduction rules is probably best achieved by looking to the underlying asset. The regulations dealing with an analogous problem, the application of the related-use test in the case of a contribution in trust of tangible personal property, assume that the charity is using the property for the same purpose as the trust, thus effectively ignoring the trust as an entity.[62] On the other hand, if the donor contributes a remainder interest that was previously transferred to him by a third party, the property interest involved should be the remainder interest itself.

With respect to charitable contributions of income interests in trust, the legislative history provides no hint as to whether the reduction rules were intended to apply. Because the donor must be taxed on the income in order to qualify for a deduction, a reduction of the contribution as a result of unrealized appreciation in the value of the underlying asset seems unduly harsh. One can argue endlessly, however, about whether the value of the income interest contributed is based upon the untaxed appreciation or the anticipated income stream. On the other hand, if the reduction rules do not apply to contributions of income interests in trust to charity, a donor might conceivably create a trust with appreciated ordinary income assets, contribute the income interest to one charity and the remainder interest to another, and thereby obtain a full, unreduced deduction without being taxed on the income. This result is clearly inconsistent with the underlying purpose of the reduction rules. Assuming, for this reason, that the reduction rules do apply to contributions of income interests in trust, the underlying trust assets should be considered the property transferred if the trust is created by the donor.

IV

AMOUNT OF DEDUCTION: PERCENTAGE LIMITATIONS

In 1917 Senator Hollis of New Hampshire, who originally proposed the charitable deduction for individuals, favored a limitation of the deduction to an amount equal to 20 percent of the donor's net income for the year:

> I should not favor allowing any man to deduct all of his contributions to these objects from his income tax return, but if we limit it to 20 percent of his income we can not be doing much harm to the Public Treasury.[63]

This concern was evidently more than shared by the Senator's colleagues since the limitation was reduced by floor amendment to 15 percent of the donor's net income.[64]

The figure against which the applicable percentage is applied to determine the limitation was changed from "net income" to "adjusted net income" in 1944 and to adjusted gross income without reduction for net operating loss carrybacks in 1954. Since 1969, this figure has been termed the "contribution base" of the donor.[65]

The Limitations in General

The limitation percentage for the income tax charitable deduction remained at 15 percent from 1917 until 1952, when it was increased to 20 percent.[66] In 1954, Congress added a considerable element of complexity to the limitation rules by granting an additional 10 percent deduction limit over and above the basic 20 percent for charitable contributions to churches, schools,[67] and hospitals.[68] As a result, the calculation of the income tax charitable deduction has since that time depended upon the status of the donee charity among charitable organizations in general.

The group of charities favored by the more liberal limitation has grown gradually in size since churches, schools and hospitals were first given favored treatment in 1954. The Tax Rate Extention Act of 1956 added medical research organizations[69] to the privileged group, and governmental units and publicly supported organizations were added in 1964.[70] The Tax Reform Act of 1969 added certain additional publicly supported[71] organizations described in § 509(a)(2) as well as pass-through foundations and pooled-fund foundations. These listed charities are now known as public charities, while all other charitable organizations are deemed private foundations.

From the beginning, the highest limitation has applied only to charitable contributions which are "to" rather than "for the use of" the recipient charity. The logic behind the "to" or "for the use of" distinction is not illuminated greatly by the legislative history. Both the House and Senate committee reports accompanying the Internal Revenue Code of 1954 merely comment that "accordingly, payments to a trust (where the beneficiary is an organization described in . . . clauses (i), (ii), or (iii)) are not included under this special rule."[72]

Over the years since 1954, this differentiation has been the subject of considerable controversy centering around the issue of whether the contribution of an income interest or a remainder interest in a trust for the benefit of a charity is a contribution "to" or "for the use of" the charity.[73] The controversy has now been resolved, insofar as the Treasury and Internal Revenue Service are concerned, by regulations which provide that any contribution of an income interest, whether or not in trust, is "for the use of" the charitable donee, while any contribution of a remainder interest, whether or not in trust, is "to" the charitable donee.[74]

In 1969 the percentage limitation rules were further complicated. The general limitation was increased from 20 percent to 50 percent,[75] but the structure of the limitation rules was completely changed to provide that this general limitation would apply only for contributions "to" certain privileged charities, while a stricter percentage limitation was retained in the case of contributions "to" private foundations and in the case of contributions "for the use of" both public charities and private foundations.

This stricter limitation is limited to the lesser of (1) 20 percent of the donor's contribution base, or (2) the excess of 50 percent of that contribution base over the amount allowable as a deduction for contributions of the donor to charities qualifying for the 50 percent limitation, determined without regard to a special limitation on contributions of capital gain property discussed below.

Through Publication 78, referred to in Chapter I above, the Internal Revenue Service provides advance notice to donors as to the status of donees as either 20 percent or 50 percent organizations.[76]

Capital Gain Property Limitation

At the same time Congress extended the general limitation to 50 percent, it imposed a separate limitation of 30 percent for contributions of capital gain property. This reduced limitation was another response by Congress to the widespread concern that appreciated property transfers to charity was an area of tax abuse.

The property subject to the 30 percent limitation is again property that would produce long term capital gain if sold. To the extent that such property is contributed to a public charity, the new 30 percent limitation will apply; as before, gifts of capital gain property to private foundations remain subject to the more restrictive 20 percent limitation. In addition, the carryover rules, which will be discussed in detail below, permit a carryover of the unused portion of capital gain property subject to the 30 percent limitation to the five succeeding taxable years of the donor, whereas contributions of such property subject to the 20 percent limitation may not be carried over to succeeding taxable years. The 30 percent limitation applies only to contributions of capital gain property that are not subject to reduction under § 170(e)(1)(B).[77]

The Tax Reform Act of 1969 did, however, provide an election to permit the donor to deduct the contribution of such capital gain property under the 50 percent limitation, provided the aggregate amount of *all* his contributions of capital gain property for that year (including any carryover capital gain property) is reduced by one half of the long term capital gain that would have been recognized had the property been sold at fair market value. As noted above, the reduction rules also enacted in 1969 impose the same treatment for *some* but not *all* gifts of capital gain property.

This election procedure developed in the course of the act's formulation as a means of resolving a conflict between the House and Senate committees. The House bill provided that all gifts of appreciated capital gain property were subject to the 30 percent limitation.[78] The Senate, on the other hand, thought it unwise to deny the additional 20 percent limitation where a capital asset or a § 1231 asset had appreciated merely a nominal amount. The Senate bill provided that only the appreciation element of capital gain property was subject to the 30 percent limitation, while the 50 percent limitation was continued for the donor's basis in the contributed property. To resolve the conflict, the conference substitute followed the House version but provided the election as a means of avoiding undue hardship in cases where the appreciation element in the contributed property is small.[79]

The 50 percent election can be made for any year in which 30 percent property is either contributed or carried over from a prior year. The regulations state that if the election is made to subject 30 percent property to the 50 percent limitation in a given year, to the extent the property involved has been carried over from a prior year, the calculation of the amount available from the carryover year must be made on the assumption that the election had been made for the prior year.[80] While the tax deduction for the prior year will not be recomputed under this rule, the effect of applying the reduction principle to the prior year may sharply reduce, or even eliminate, the amount available for deduction in the carryover year. For example, assume a hypothetical donor whose contribution base for 1972 is $100,000 and whose contribution base for 1973 is $80,000. Assume further that in 1972 the donor contributes $20,000 in cash to his church and $40,000 in marketable securities, which have a cost basis of $20,000, to his college. During 1973, the donor makes an additional contribution of $40,000 to his college in the form of marketable securities with a cost basis of $38,000. In order to make the entire 1973 contribution deductible in that year, he elects to treat the 1973 contribution as 50 percent property and forego $1,000 of the value of the gift. While the election might well have produced attractive results for the donor in 1973, it will cause a loss of a $10,000 carryover of 30 percent property from 1972. Had the election not been made, $10,000 of the 1972 securities gift would have been carried over as a contribution of 30 percent property ($50,000 contribution base, less the 50 percent property gift of $20,000, left only $30,000 of the $40,000 securities gift deductible in 1972). However, the 1973 election requires that the donor assume that the 30 percent property gifted in 1972 was similarly reduced to cost basis plus one half of the appreciation, so that its assumed value in 1972 of $30,000 would leave no excess contribution carryover to 1973 and subsequent years. Since the election must be made with respect to all 30 percent property contributions for the year in question, including carryover 30 percent property, the aggregate impact of the election must be studied carefully to determine whether the donor in a particular case will actually obtain benefit through use of this option.

There are several situations in which it might be advantageous for a donor to consider this 50 percent election, although each appears to be of more theoretical than practical importance. If the appreciation element in the property is relatively insignificant in comparison with the current tax savings afforded by the increase in the deduction limit from 30 percent to 50 percent, the donor may well decide that the increased current tax savings will more than offset the loss of a deduction, both for the year in question and future years under the carryover rules, for one half of the appreciation element. This will be particularly true if the donor is likely to make additional contributions of 30 percent property in subsequent years, thus possibly postponing for more than one year the availability of the deduction under the carryover rules for the initial transfer.

Another situation in which a donor may benefit from the election is where there is a risk that due to the amount of his charitable contributions for the year, he stands to lose all or a portion of his 20 percent contributions. Since these 20 percent contributions cannot be carried over to future years, an election to reduce the value of the 30 percent property might permit the 20 percent property to be deducted in the current year. An example illustrating a situation of this type is set forth in the following section.

Interrelationship of Limitations

Each of the 20 percent, 30 percent, and 50 percent limitations are relatively straightforward when considered separately, but when multiple charitable contributions are made in a given taxable year, some of which are subject to one percentage limitation and some to another, the computation can become exceedingly complex and the interplay of the limitations can lead to surprising results.

There does not appear to be any basic incompatibility between the rules governing contributions of 50 percent property and 30 percent property, because the last sentence of § 170(b)(1)(D)(i) provides that " . . . contributions of capital gain property to which this paragraph applies shall be taken into account after all other charitable contributions." Assume, for example, that a hypothetical donor, whose contribution base for the year is $100,000, contributes $40,000 in cash to his church and $10,000 in highly appreciated securities to a college. The entire $50,000 will be deductible in the current taxable year, since the $40,000 cash contribution will leave $10,000 of the 50 percent limitation available for the appreciated property after "all other charitable contributions" have been taken into account for the taxable year. If the gift of securities was $25,000, however, with a cost basis of $10,000, the deduction during the year of transfer would still be limited to $10,000, and the donor would then have to carry $15,000 over to subsequent years still subject to the 30 percent limitation. It should be noted that the 50 percent election for contributions of capital gain property would not benefit the donor in this factual situation, since the aggregate contributions during the year in question were already subject to the 50 percent limitation without the reduction in value for one half of the appreciation attributable to the 30 percent property.

On the other hand, it is possible for gifts of 30 percent property either to reduce the value of gifts of 20 percent property or cause a complete wastage of some or all of such gifts. This result can occur because the deduction afforded to gifts of 20 percent property is limited to the lesser of the excess of the 50 percent limitation available after taking into account the aggregate of the donor's gifts that year to public charities, or 20 percent of his contribution base. In the computation of this offset for gifts to public charities, the 30 percent limitation on gifts of 30 percent property does not apply. Thus, for example, assume that during a single taxable year, the hypothetical donor with a $100,000 contribution base contributes $10,000 in cash in the United Appeal, highly appreciated securities with a fair market value of $40,000 to his college, and $10,000 in cash to a private foundation. As we have seen, the interrelationship of the 50 percent and 30 percent limitations is such that the 50 percent property must be considered first. Therefore, the donor can deduct the $10,000 cash contribution to United Appeal under the 50 percent limitation. This leaves $40,000 of deductions for other contributions. Because the contribution of appreciated securities is subject to the 30 percent limitation, so that $10,000 of that gift must be carried over to a succeeding taxable year, one would expect that $10,000 of deductions under the limitations will be left to cover the cash gift to the private foundation. The 20 percent limitation, however, is defined as the excess after all 50 percent property has been contributed, including 30 percent property irrespective of whether it is currently deductible or not. For purposes of determining whether the 20 percent limitation permits the deduction for the cash contribution to the private foundation, therefore, the impact of the gift of appreciated property must be computed at its full value of $40,000, which, when added to the $10,000 contributed to the United Appeal, reduces the 20 percent limitation for that year to zero. In effect, this combination of charitable contributions has caused a total wastage of the cash gift to the private foundation. Moreover, although the donor will be entitled to carry over the $10,000 of unused 30 percent property contribution to a succeeding taxable year, the nondeductible portion of the 20 percent property cannot be carried over to subsequent years and is lost forever.

This result may be avoided if the donor, through careful planning, limits the gift of appreciated securities to his college to $30,000, so that only the amount actually contributed and deducted that year would be used in determining the availability of the 20 percent limitation for the cash gift to the private foundation.

This donor might also consider the election to reduce the gift of appreciated securities by 50 percent of the appreciation element, thereby qualifying the gift for the 50 percent limitation rather than the 30 percent limitation. Assuming that the securities had a basis of $20,000, this election would reduce the value of the property contributed to $30,000 (basis of $20,000 plus 50 percent of the appreciation element, or $10,000), so that the aggregate gifts qualifying for the 50 percent limitation would be $40,000, and the limitation available for 20 percent property would be $10,000, or an amount equal to the actual gift. It is obvious, however, that salvaging the $10,000 cash gift to the private foundation requires the loss of $10,000 of the capital gain property gift, which may well have otherwise been carried over and deducted in a succeeding year.

Carryover Rules

Prior to 1964, charitable contributions by individuals in excess of the amount that could be deducted in the current year under the percentage limitation rules were wasted. Contributions by corporations, on the other hand, in excess of the applicable percentage limitation could be carried forward to the following two years.

In 1964, the House Ways and Means Committee proposed an extension of the carryover for corporate[81] donors from two to five years. The Senate Finance Committee in turn added an amendment to the bill to allow individual donors to carry over the excess of their contributions qualifying for the higher percentage limitation.[82] There were several purposes behind the proposed carryover. First, it was argued that there was no reason for allowing a carryover to corporate donors but not to individual donors. Second, the carryover provision, along with the income averaging provisions enacted in the same year, were part of a policy favoring the computation of income for tax purposes "over a long period of time rather than on an annual basis." Third, the carryover was thought to be desirable generally:

> More important, however, this will make it unnecessary for taxpayers desiring to make a contribution of a substantial nature to a charitable organization to carefully divide the gift into parts, contributing each in a separate year, or perhaps giving undivided interests in a property, up to their applicable limitation, to the charitable organization in each of a series of years. Not only is the present practice complicated for the donor, but it also creates problems for the charitable or educational organization. Where they are given undivided interests in a property over an extended period of time, they may find it impossible either to sell or use the property over this same period of time while their interest in it gradually increases from year to year.[84]

Under §§ 170(d)(1) and 170(b)(1)(D)(ii), the value of 50 percent and 30 percent property, which is transferred "to" rather than "for the use of" public charities and which can not be deducted in the year of transfer because of the application of the 50 percent and 30 percent limitations, may be carried over to the five succeeding taxable years of the donor.[85] This excess deductions carryover privilege is personal to the donor and may not be transferred to his estate. Thus, if unused excess deductions cannot be used on the decedent's final income tax return, they are lost. Excess deductions subject to the 20 percent limitation may not be carried forward to future years.

In situations where the donor makes additional charitable contributions during the succeeding taxable year or years to which excess contributions under the 50 percent limitation or the 30 percent limitation, or both, are carried, the determination of the charitable deduction for the succeeding taxable year will depend upon a careful tracing of the contributions involved and an understanding of their priorities under the limitation rules. Fortunately, the regulations clarify to a considerable degree the rules involved.

First, it is clear that the existence of excess contribution carryovers imperils charitable contributions subject to the 20 percent limitation in the years to which those excess contributions are carried forward. For example, assume the donor has a tax contribution base of $100,000 in 1973 and $80,000 in 1974. Assume further that in 1973 he makes a charitable contribution of $55,000 in cash to his church and $5,000 in cash to a private foundation. Subsequently, in 1974 the donor makes a gift of $35,000 in cash to his church and $2,500 in cash to the same private foundation. In 1973, $50,000 of the $55,000 contribution to the church will be deductible under the 50 percent test and the balance of that $5,000 will be carried forward to 1974 as 50 percent property. Because the 50 percent limitation was reduced to zero by the cash contribution to the church, the $5,000 contribution to the private foundation is not deductible and cannot be carried forward to the following year. In 1974, the $5,000 church contribution carried forward from 1973, together with the new $35,000 cash contribution to that church, will absorb the entire 50 percent limitation, thus again eliminating the cash contribution to the private foundation, which is subject to the 20 percent limitation.[86]

Second, the regulations make it clear that contributions of 50 percent property and 30 percent property that are actually paid during a year are considered before carryover contributions in the determination of the charitable deduction for that year.[87]

Third, in the event that after deducting contributions actually made during the current year, the 50 percent limitation has not been met, excess contributions subject to the 50 percent limitation carried over from prior years will be applied (in order of seniority) first against the unused limit. Then, to the extent the excess contributions of 50 percent property have not absorbed the percentage limitation, excess contributions of 30 percent property may be carried over, but only to the extent that the 30 percent limitation for the subsequent year is available.[88]

These rules are illustrated by a series of examples set forth in the regulations.[89] While these examples are not terribly complicated in and of themselves, the nature of the calculations makes it impractical, from the standpoint of this paper, to abstract and present these examples in simplified form. The results of these examples do, however, support the priority rules noted above, namely, that in any given year contributions are taken into account in the following order:

1. gifts qualifying under the 50 percent limitation actually made during the taxable year;

2. gifts of 30 percent capital gain property actually made during the taxable year;

3. to the extent that the overriding 50 percent limitation is not absorbed, contributions carried over from gifts in prior years which qualify (or are treated as having qualified under the 50 percent limitation election) under the 50 percent limitation;

4. to the extent that the 30 percent limitation is not absorbed (and subject to

the overriding 50 percent limitation), excess contributions of 30 percent capital gain property carried over from gifts in prior years are taken into account; and, finally,

5. gifts of 20 percent property actually made during the taxable year.

Presumably, a donor faced with several years of current charitable contributions and excess contribution deductions carried over from prior years will reach the point of foregoing contributions in the current year in order to catch up, and eliminate, his excess contributions from prior years. Otherwise, at some stage the system of computing the amount deductible under § 170 would bring the donor and his advisors to the point of complete exhaustion. The regulations require that should a donor claim a deduction in respect of an excess charitable contribution, the burden is upon him to attach a schedule to his return illustrating the computation under which that deduction has been claimed.[90]

V

BARGAIN SALES

The problems attendant to transfers of appreciated property to charity are probably best illustrated by so-called "bargain sale" transactions in which the property is sold to charity at a price below fair market value. Prior to 1969, the donor in a bargain sale recovered his investment tax free so long as the sale price did not exceed the adjusted cost basis for the property. He also received a charitable deduction for the difference between the fair market value of the property and the sale price.[91] If the transaction was structured to equate the sale price to the donor's adjusted cost basis for the property, these rules permitted the donor to recover his entire investment in the property in cash or other consideration and also to receive an income tax charitable deduction for the entire appreciation element.[92] The fact that the donor could at least partially convert the transferred property to cash further aggravated congressional concern about the tax abuse normally associated with appreciated property transfers.

In the Tax Reform Act of 1969, the rules were amended to deal with these perceived abuses.[93] The House Ways and Means Committee proposed an amendment providing that where "a deduction is allowable under § 170 . . . by reason of a sale," the donor's adjusted basis in the property must be allocated between the portion sold and the portion contributed. The Senate Finance Committee deleted this provision on the grounds that it would "adversely affect giving to charities, as 'bargain sales' have been a long-accepted form of making contributions of property to charities,"[94] but the conference substitute adopted the House position.

This new basis rule is contained in § 1011(b), and it requires that the adjusted cost basis of property transferred in a bargain sale be allocated between the portion considered sold and the portion considered contributed in the ratio of the amount realized on the transfer by the donor to the remaining fair market value of the transferred property.[95] For example, assume that a donor sells property worth $20,000 to a charity for $10,000, which is the amount of his adjusted cost basis in the property. If the transaction took place prior to 1969, the donor would have received the $10,000 from the charity tax free as a recovery of his cost basis and would also have received a $10,000 income tax charitable deduction. Following the basis rule change in 1969, the donor is allowed the same charitable deduction of $10,000 (assuming the reduction rules do not apply), but he will realize income of $5,000 because his basis in the portion of the property deemed sold has been reduced by 50 percent from $10,000 to $5,000 through the basis adjustment.

With one exception, the joint application of the new bargain sale rules and the reduction rules places the donor in the above transaction in exactly the same position as if the property transferred to the charity had been sold and cash equal to the value of the gift element contributed to charity. The exception involves the bargain sale of capital gain property to a public charity where, because the reduction rules are inapplicable, the donor is better off structuring the gift as a bargain sale.

Interaction With Percentage Limitations

As noted above, the bargain sale basis allocation rule applies only "if a deduction is allowable under § 170 . . . by reason of a sale." This prerequisite creates problems when, by reason of the percentage limitations, no deduction is allowed in the year of the bargain sale. Neither the statute nor the regulations provide assistance in dealing with this circumstance, which is complicated by the fact that the donor may obtain a deduction in a later year due to the carryover. If the bargain-sale rule is nevertheless applied in a year in which no charitable deduction is allowed, it should be recognized that the carryover privilege may not produce a deduction, because of either the amount of charitable contributions actually made in those future years or the death of the donor. In addition, application of the rule in this instance would certainly penalize bargain sales to private foundations, where the carryover rules are unavailable and the donor would be forced to recognize income without a corresponding deduction.

On the other hand, if the bargain-sale rule does not apply in this circumstance, the result might lead to avoidance possibilities for high-bracket taxpayers, who could time bargain sales to coincide with other sizeable charitable contributions and thereby effectively blunt the impact of the basis adjustment. Application of the bargain-sale rule would also avoid the need for tracing rules to determine which contributions for the year in question were, in fact, carried over.

It thus appears preferable, on balance, for the bargain-sale rule to apply even in those years where the donor's percentage limitation is exceeded. Although this result may be somewhat harsh on bargain sales to private foundations, the lack of hospitality in the tax laws for charitable contributions to private foundations is now well known and should presumably alert prospective donors that unintended tax results may occur in this area unless the rules are carefully anticipated.

Exchanges

Another problem, also raised by the phraseology of § 1011(b), is whether a "sale" includes an "exchange." Assume, for example, that a donor exchanges one piece of property worth $1,000 to a charity for another piece of property worth $500. The applicability of § 1011(b) is an important issue even if the transaction is a "like-kind" exchange governed by § 1031 (so that income is not recognized on the exchange), because the basis of the donor in the property received is carried over from his basis in the property exchanged. Although a strong argument can be made that the term "sale" does not include an exchange, based upon the conjuctive use of the term "sale or exchange" elsewhere in the Code when the opposite meaning is intended, the regulations, perhaps cavalierly, add "or exchange" to the word "sale" in this context.[96]

Interaction With Reduction Rules

The statutory provisions involved do not expressly prevent the tandem application of the bargain sale basis adjustment and the appropriate reduction rules to either a bargain sale of unrelated use tangible personal property to a public charity or a bargain sale of any property to a private foundation. Assume, as above, that property with a fair market value of $20,000 is sold to charity at a price equal to its basis of $10,000. Although a pro rata portion of the donor's basis is allocated to the portion sold, the donor has still transferred the other portion of appreciated property to charity. Unless the reduction rules are applied, the donor will obtain a deduction based upon the appreciation element in the property.

The regulations do state that the reduction rules will not be applied "where, by reason of the transfer of the contributed property, ordinary income or capital gain is recognized by the donor."[97] This exception should not be applied literally in the bargain sale context because the recognition of income involved is attributable only to the portion of the property sold and no recognition occurs "by reason of the transfer" of the contributed portion.

The interrelationship of the basis-allocation provision and the ordinary income property reduction rule is confusing. Assume, for example, that ordinary income property with a fair market value of $20,000 is sold by a donor to a charity at the donor's basis of $10,000. If the reduction rule in § 170(e)(1)(A) applies first, the amount of the contribution is reduced to zero and, as a result, the basis-allocation provision of § 1011(b) does not apply because there is no deduction allowable under § 170. If the basis-allocation provision is taken into account first, the donor's basis of $10,000 is allocated equally between the portion contributed and the portion sold. The donor must recognize gain of $5,000 on the portion sold, while he receives a contribution deduction of $10,000, which § 170(e)(1)(A) reduces to $5,000. Whichever provision is applied first, the amount of the contribution allowed, if any, is offset by the amount of gain recognized.[98] However, if the percentage limitations came into play or the amount of the donor's gross or adjusted income is an issue in the year the transfer takes place, a real problem exists which is not solved by either the statute or the regulations.

Charitable Transfers in Exchange for Annuities

The regulations define a bargain sale to include a transfer of property to charity in exchange for an agreement by the charity to pay the donor an annuity (presumably with a discounted value which is less than the value of the property contributed).[99] The regulations defer recognition of the resulting gain for the bargain-sale transaction provided (1) the annuity is nonassignable or is assignable only to the donee charity and (2) the only annuitants are either the transferor or the transferor and a designated survivor or survivors. Otherwise, the donor is taxed in the year of the sale on the amount by which the present value of the annuity exceeds the portion of his basis allocated to the sale. If the deferral conditions are met, gain equal to the excess of the present value of the annuity over the allocable portion of basis is recognized ratably over a period of years measured by the applicable expected return multiple found in the tables contained in the regulations under § 72. In the event the transferor dies or relinquishes the annuity to the charitable donee prior to recognizing the entire gain, no tax is imposed on the additional gain.

Charitable Transfer Subject to or in Exchange for the Donee's Assumption of Debt

The implications of the new bargain-sale rules extend beyond the true bargain sale to include transfers in which the property is not actually sold to charity. Thus, a donor who transfers appreciated property that is subject to a debt obligation to a charity will realize income to the extent the obligation is relieved as a result of the transfer.[100] The bargain-sale rules treat any indebtedness on property transferred to charity as an amount realized by the donor, regardless of whether the charity agrees to assume or pay the indebtedness.[101] To the extent the obligation exceeds the donor's adjusted tax basis not allocated to the gift portion of the property, the donor will realize taxable income from the transaction.

VI

CONCLUSION

The panoply of rules and restrictions now embodied in § 170 and noted in the preceding analysis assures the conclusion that any effort to summarize this statute is risky. A given charitable contribution may create a number of interdependent issues, including the amount of the donor's contribution base; the character, fair market value and cost basis of the property transferred; the classification of the donee charity; the applicability of the reduction rules to the property transferred; the interplay of the limitation rules; and the method of transfer involved. In many cases the controlling rules must be applied in conjunction with other sections of the Internal Revenue Code. All in all, the process of determining the proper income tax charitable deduction is not easily digested. Several general propositions, however, may be drawn from this analysis of § 170.

First, there is no doubt that the present income tax laws favor public charities over private foundations. The availability of higher percentage limitations and carryover privileges, as well as relief from the reduction rules for transfers of appreciated capital gain property and related use personal property to public charities, demonstrate this favoritism.

Second, it is evident that congressional zeal for preventing tax abuse in the context of charitable transfers has consistently been tempered with a concern that the tax law should encourage rather than discourage private support of charitable organizations. Obviously, any effort to curb undue tax breaks for transfers to charity may inhibit this support incentive. In the process of balancing tax equity with the desirability of charitable support from the private sector, Congress has, not surprisingly, enacted compromise measures. Perhaps the appreciated-property rules best illustrate this fact. For years Congress has recognized that a charitable deduction based upon the fair market value of the property contributed affords the donor of appreciated property the double benefit of a deduction and an exclusion from income for the appreciation element. A proposal to limit the deduction for transfers of property other than money to the lower of adjusted cost basis or fair market value at the time of transfer was proposed in Congress in 1938 to deal with this apparent tax loophole. Yet, for the most part, reform in this area was deferred until 1969. In the Tax Reform Act of 1969, when Congress dealt with the appreciated property problem in depth, an overall reduction rule was rejected in order to protect transfers of appreciated capital gain property and related use tangible personal property to public charities. As a result, the reduction rules adopted involved more than 20 separate amendments to existing tax laws.

This manner of resolving the tension between the concepts of tax equity and encouragement of private philanthropy illustrates the third general proposition, namely, that the present income tax charitable deduction has clearly become unduly complex. Section 170 is, at best, a hodgepodge of rules and restrictions which are difficult to interpret and present Congress and taxpayers alike with opportunities to match wits to see how these rules may be used to advantage. The consequences have recently been described as follows:

> The process by which tax advisors discover loopholes and other tax experts (on the other side of the regulatory fence) concoct reform provisions involves a highly sophisticated form of legal engineering. The result is generally not a simple plug, but an intricate network of dikes and sluices. Simple rules, it seems, will not go far enough, or will go too far; there are always special cases requiring exceptions, adjustment, and other fillips; and care must be taken to ensure that the experts who thought of the loophole cannot devise another scheme to avoid the corrected rule.[102]

It cannot reasonably be expected that such a time-honored system will be easily simplified.

It should be recognized, however, that the appreciated property problem and the distinctions between transfers to public charities and private foundations account for a large portion of the present complexity of § 170. If transfers of appreciated property and money produced identical results, and if the deduction rules were similar for transfers to public charities and private foundations, the reduction rules in § 170 would disappear and only one general limitation of the type initially provided in 1917 would be necessary. In fact, the present statute, with the exception of the additional categories of qualified organizations and the rules relating to deferred giving, would look much like its original progenitor.

Thus, it becomes clear that the issue of tax simplification is very much at stake when decisions are made between the competing values of tax equity and encouragement of private charitable giving in the realm of the income tax charitable deduction.

Footnotes

1. *See, e.g.*, 55 Cong. Rec. 6728 (1935) (remarks of Senator Hollis); 79 Cong. Rec. 12423 (1935) (remarks of Representative Treadway). In this regard, the House Report stated that the deduction "[I]s based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds." H.R. Rep. No. 1860, 75th Congress, 3rd Session 19 (1938).

2. *See, e.g.*, Devine, *Social Forces in Wartime*, The Survey, July 17, 1917.

3. *See, e.g.*, *Exemption of Contributions*, Boston Transcript, June 29, 1917.

4. For example, proponents of the matching grant proposal as an alternative to the present tax deduction scheme emphasize the theory of the deduction as a subsidy or means of perpetuating the flow of private support to charity. *See, e.g.*, McDaniel, *Federal Matching Grants for Charitable Contributions; A Substitute for the Income Tax Deduction*, 27 *Tax L. Rev.* 377 (1972). Those favoring reform within the context of the present income tax deduction, on the other hand, refer to the original theory that amounts directed to charity are not part of an individual's consumable income and conclude that the charitable deduction should not be considered a governmental subsidy for charity since the income tax falls properly on a taxpayer's income which is available for his own consumption and not that which is directed toward charity. *See, e.g.*, Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *Harv. L. Rev.* 1113 (1974).

5. For an in-depth discussion of corporate contributions, see the separate paper, "Corporate Charitable Contributions," prepared for the Commission on Private Philanthropy and Public Needs by R. Palmer Baker, Jr., and J. Edward Shillingburg of the firm of Lord, Day and Lord.

6. Code of 1954 § 508(*d*)(1). *See also* Rev. *Proc.* 72-39, 1972-2 Cum. Bull. 818.

7. Int. Rev. Code § 508(*d*)(2)(A).

8. Int. Rev. Code § 508(*d*)(2)(B).

9. § 1.170A-1(c)(2).

10. In the case of contributions of art objects, for example, the Internal Revenue Service has established an advisory panel of ten art experts to determine whether taxpayers have placed realistic fair market value appraisals of art objects donated to charity. IRS News Release, February 1, 1968, 687 CCH 1968 Stand. Fed. Tax Rep. ¶ 6573.

11. This restriction arose out of court decisions and a revenue ruling dealing with educational organizations practicing racial discrimination. In *Coit v. Green,* the Supreme Court affirmed per curiam the opinion of the District Court for the District of Columbia, holding that a deduction under § 170 was not allowable for contributions to racially segregated educational organizations because such segregation was contrary to the public policy of the United States. *Green* v. *Connally*, 71-2 USTC ¶ 9529 (D.D.C. 1971), *aff'd per curiam sub nom., Coit* v. *Green*, 72-1 USTC ¶ 9123 (S.Ct. 1971). *See also,* Rev. Rul. 71-447, 1971-2 Cum. Bull. 230; Rev. Rul. 67-325, 1967-2 Cum. Bull. 113. In *McCoy v. Shultz*, 73-1 USTC ¶ 9233 (D.D.C. 1971), the issue of whether U.S. public policy prevented the deduction of contributions to an organization which was alleged to discriminate on the basis of sex was raised but not considered.

This public policy restriction will presumably be limited in application to situations where there is a strong and clear federal policy at stake. Although the decision in *Green* appears to rest primarily on the "well-established principle that the Congressional intent in providing tax deductions and exemptions is not construed to be applicable to activities that are either illegal or contrary to public policy," the decision was "fortified . . . by the consideration that a contrary interpretation of the tax laws would raise serious constitutional questions." It can thus be argued that serious constitutional difficulties dictated the decision in *Green* and that only federal policy of a constitutional magnitude can properly by asserted through this otherwise open-ended doctrine.

12. Revenue Act of 1924, Pub. L. No. 68-176, § 214(a)(10), 43 Stat. 253.

13. Revenue Act of 1913, Pub. L. No. 16, § II. G(a)[2][f], 38 Stat. 114.

14. Those organizations which are today described in Int. Rev. Code § 501(c)(3). It should be pointed out, however, that the category of donee organizations described in Int. Rev. Code §§ 170(c)(2) is not identical to the category of exempt organizations described in Int. Rev. Code § 501(c)(3). For example, Int. Rev. Code § 170(c)(2) requires that the organization be organized in the United States or in a possession thereof, while Int. Rev. Code § 501(c)(3) does not.

In addition, the Internal Revenue Service ruled in 1954 that contributions to other classes of tax exempt organizations will qualify as charitable contributions if they are earmarked for separate funds maintained by such organizations exclusively for religious, charitable, scientific, literary or educational purposes. *See* Rev. Rul. 54-243, 1954-1 Cum. Bull. 92.

15. This restriction was later reworded so as to limit these organizations to those which were "created or organized" in the United States. The Service has interpreted this restriction to disallow the deduction for contributions which are to a domestic charity in certain cases. For example, where a foreign organization creates a domestic organization to raise funds in the United States, contributions to the domestic organization do not qualify. Similarly, contributions to a domestic organization whose charter provides that all its funds will be remitted to a foreign organization and contributions paid to a domestic organization on the representation that they will be paid to a foreign organization do not qualify. Contributions otherwise

qualifying as charitable are not disqualified, however, merely because the donee conducts charitable activities both at home and abroad, even where the activities conducted abroad are, for reasons of administrative convenience, conducted through a foreign subsidiary. *See* Rev. Rul. 63-252, 1963-2 Cum. Bull. 101; Rev. Rul. 66-79, 1966-1 Cum. Bull. 48; Rev. Rul. 69-80, 1969-1 Cum. Bull. 65.

16. The stated purpose of the provision was to "[E]ncourage taxpayers to take into their homes Indian children, and also foreign children whose presence in this country is sponsored by a charitable institution under a program of the organization designed to provide educational opportunities for pupils or students in private homes. S. Rep. No. 1767, 86th Congress 2d ~~Session 10 (1960)~~.

17. For an in-depth analysis of such interpretative issues, the reader is referred to the separate paper "Criteria For Exemption under Section 501(c)(3)," prepared for the Commission by John P. Persons, John Jay Osborn, Jr., and Charles F. Feldman of the firm of Patterson, Belknap & Webb.

18. Rev. Proc. 72-39, 1972-2 Cum. Bull. 818.

19. Rev. Proc. 72-4, 1972-1 Cum. Bull. 706, at § 7.02.

20. Rev. Proc. 72-39, 1972-2 Cum. Bull. 818, at § 3. The authority of the Internal Revenue Service to honor such reliance is provided by Int. Rev. Code § 7805(b).

21. Tax exempt private foundations, which are subject to excise tax under Int. Rev. Code § 4945(d)(5) if they contribute to non-qualifying organizations, will be especially reluctant to depart from Publication 78.

22. The importance of a Publication 78 listing is well illustrated by the legal battle waged by Bob Jones University when the Internal Revenue Service revoked its listing because of its reputed racial discrimination. The University attempted to enjoin the Service from revoking its § 501(c)(3) and § 170(c)(2) ruling letter and its listing in Publication 78 by alleging irreparable harm from lost contributions. The Supreme Court affirmed the decision of the Court of Appeals denying the injunction on the ground that the University failed to show that under no circumstances could the government prevail. *Bob Jones University v. Simon*, 72-1 USTC ¶ 9245 (D.C. 1972), *rev'd*, 73-1 USTC ¶ 9815 and ¶ 9036 (4th Cir. 1973) *aff'd*, 74-1 USTC ¶ 9483 (S. Ct. 1974).

23. Rev Proc. 72-39, 1972-2 Cum. Bull. 818, 819, at ¶ 4.03.

24. These new rules governing life estates and remainders, in trust and outright, are set forth in Int. Rev. Code § 170(f).

25. *See, e.g.*, H.R. Rep. No. 91-413 (Part 1), 91st Congress, 1st Session 58-59 (1969). *See also* Treas. Reg. § 1.170A-1(e) and Taggart, *The Charitable Deduction*, 26 *Tax L. Rev.* 63, 96 (1970).

26. Int. Rev. Code § 664(d)(1).

27. Int. Rev. Code § 664(d)(2).

28. Int. Rev. Code § 642(c)(5).

29. *See* H.R. Rep. No. 91-413 (Part 1), 91st Congress., 1st Session 58-59 (1969),

30. Int. Rev. Code § 170(f)(4).

31. Treas. Reg. § 1.170A-6(b) provides that remainders in pooled income funds, charitable remainder annuity trusts, and charitable remainder unitrusts be valued in accordance with Treas. Regs. § 1.642(c)-6, § 1.664-2, and § 1.664-4, respectively.

32. Int. Rev. Code § 170(f)(2)(B).

33. *See* Treas. Reg. § 1.170A-6(c)(3).

34. *See* H.R. Rep. No. 91-413 (Part I), 91st Congress, 1st Session 60-62 (1969).

35. Int. Rev. Code § 170(f)(2)(D) and Treas. Reg. § 1.170A-6(a)(1).

36. Treas. Reg. § 1.170A-7(a)(2)(i).

37. Treas. Reg. § 1.170A-7(a)(2)(ii).

38. Treas. Reg. § 1.170A-7(b)(1)(i).

39. *See* Treas. Reg. § 1.170A-7(b)(1)(ii), presumably based upon the following statement contained in the conference committee report: "The conferees on the part of both Houses intend that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity." H.R. Rep. No. 91-782, 91st Congress, 1st Session 294 (1969).

40. *See* Treas. Reg. § 1.170A-7(b)(3).

41. Int. Rev. Code § 170(f)(4).

42. Rev. Rul. 55-410, 1955-1 Cum. Bull. 297; Rev. Rul. 55-138, 1955-1 Cum. Bull. 223. Measuring a contribution by its value rather than the donor's tax basis in the property contributed has resulted in a continuing definitional problem in light of the fact that contributions of personal services have never been deductible. This fact would not create any particular problems if contributions of property were measured by the donor's basis because a donor has no basis in his personal services. But because the amount of a contribution, if considered to be of property rather than of services, is equal to its value, the issue is often raised of distinguishing services from property. *See, e.g.,* Rev. Rul. 162, 1953-2 Cum. Bull. 127 (donation of blood is a donation of services); J.R. Holmes, 57 T.C. 430 (films produced by donor were property); B. Goss, 57 T.C. 594 (essays prepared by donor were property).

43. The donee charity, being tax exempt, can of course dispose of the stock without being taxed. *See* Rev. Rul. 57-328, 1957-2 Cum. Bull. 229.

44. The proposed amendment was explained by the Report of the House Ways and Means Committee as follows: "If a charitable contribution is made in property other than money the donor is permitted to deduct the value of the property at the time of the gift, and is not limited to the cost of the property to him. It is, therefore, to the donor's advantage to make contributions in securities or other property which has appreciated in value and in this way avoid tax upon the unrealized capital gain. There is no justification in principle for the allowance of a deduction for the amount of unrealized appreciation which has never been included in taxable income." H. Rep. No. 1860, 75th Congress, 3rd Session 20 (1938).

45. The report of the Senate Finance Committee states as follows: "Representations were made to the committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in kind. The committee believes that charitable gifts generally ought to be encouraged and so has eliminated this provision of the House Bill." S. Rep. No. 1567, 75th Congress, 3rd Session 14 (1938).

46. *See* H.R. Rep. No. 91-413, 91st Congress, 1st Session 53 (1969). The reduction rules are discussed in detail in "Legal Aspects of Charitable Contributions of Appreciated Property to Public Charities," prepared for the Commission by Harry Mansfield and Ronald Groves of the firm of Ropes & Gray.

47. Int. Rev. Code § 170(e)(1)(A). This provision effectively removes the reason for the controversy described in footnote 42 above, resulting from the property/services distinction. Because property developed by personal efforts or services normally generates ordinary income on sale, the amount of a contribution of such property is the donor's basis, which is zero unless he has incurred out-of-pocket expenses in creating it. As a result, the only reason for continuing controversy on this front arises from the position of the Service that a contribution of the property is "to" a charity, while out-of-pocket expenses incurred in performing services are "for the use of" the charity. *See* Rev. Rul. 58-279, 1958-1 Cum. Bull. 145.

48. Int. Rev. Code § 170(e)(1)(B)(i).

49. Int. Rev. Code § 170(e)(1)(B)(ii).

50. Int. Rev. Code § 170(e)(1)(B)(iii).

51. Treas. Reg. § 1.170A-4(b)(4).

52. Taggart, *supra* note 25, at 121.

53. Treas. Reg. § 1.170A-4(b)(3).

54. Furthermore, the regulations provide that a sale of an insubstantial portion of a set or collection of tangible personal property donated does not make the charity's use unrelated. Ibid.

55. Ibid.

56. Taggart, *supra* note 25, at 122.

57. *See* Rev. Rul. 55-157, 1955-1 Cum. Bull. 293.

58. *U.S. Treasury Dept., Summary of Tax Reform Proposals* (April 21, 1969).

59. Treas. Reg. § 1.170A-4(a).

60. Treas. Reg. § 1.170A-6(b).

61. *See* Taggart, *supra* note 25, at 114-115.

62. Treas. Reg. § 1.170A-4(b)(3)(i).

63. 55 Cong. Rec. 6728 (1917) (remarks of Senator Hollis).

64. *See, e.g.*, 55 Cong. Rec. 6729 (1917) (remarks of Senator Simmons).

65. In 1969, the Senate rejected the House proposal to change the base to include adjusted gross income plus the amount of tax preferences not included in the tax base.

In the case of a husband and wife filing a joint return, the aggregate contributions of the couple are limited to the applicable percentage applied against the contribution base of the couple. *See Taft* v. *Helvering*, 40-2 USTC ¶ 9828 (2nd Cir. 1940).

66. The stated purpose for liberalizing the percentage limitation was to further stimulate support of charitable institutions. *See* S. Rep. No. 1584, 82d Congress, 2d Session 2 (1952).

67. Educational organizations described in Int. Rev. Code § 503(b)(2), prior to the Tax Reform Act of 1969.

68. Hospitals described in Int. Rev. Code § 503(b)(5), prior to the Tax Reform Act of 1969.

69. Medical research organizations described in Int. Rev. Code § 503(b)(5), prior to the Tax Reform Act of 1969.

70. The stated congressional purpose behind the expansion of the privileged group of donee organizations was to accomplish "greater uniformity in the availability of this additional 10-percent deduction" among gifts which were likely to be put to immediate charitable uses, because they are made directly to public charities, private operating foundations, or foundations making immediate distributions of all contributions. The more restrictive limitation was retained in the case of contributions to private foundations generally, on the ground that these types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately

spendable receipts of contributions for charitable organizations. H.R. Rep. No. 749, 88th Congress, 1st Session 53 (1963).

71. The criteria for determining whether an organization is "publicly supported" are set forth in Treas. Reg. § 1.170A-9(e). This regulation provides that an organization will be treated as "publicly supported" if the total amount of support which the organization has received for each of the four taxable years immediately preceding the current taxable year from governmental units, contributions made directly or indirectly by the general public, or a combination of these sources, equals at least one-third of the total support received during each of those years. Treas. Reg. § 1.170A-9(e)(2) and (4). Organizations failing to meet this test but which have received at least 10 percent of the *aggregate* of their support over the preceding four years from such sources and which have maintained continuous and bona fide programs for solicitation of funds from such sources may still be treated as "publicly supported" if they can establish, on the basis of certain prescribed factors, that they normally receive a substantial part of their support from such sources. Treas. Reg. § 1.170A-9(e)(3) and (4). The distinction between public and private charities is discussed in detail in "An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations," prepared for the Commission by Laurens Williams and Donald V. Moorehead of the firm of Sutherland, Asbill & Brennan.

72. H. Rep. No. 1337, 83d Congress, A53 (1954); S. Rep. No. 1622, 83d Congress, 2d Session 207 (1954).

73. *See e.g.*, Rev. Rul. 57-507, 1957-2 Cum. Bull. 511; Rev. Rul. 57-562, 1957-2 Cum. Bull. 159; T.I.R. No. 792, 667 CCH 1965 Stand. Fed. Tax Rep. ¶ 6351 (Dec. 17, 1965); John I. Appleby, 48 T.C. 330 (1967); Alice Tully, 48 T.C. 235 (1967).

74. Treas. Reg. § 1.170A-8(a)(2).

75. One apparent reason for the increase in the general limitation from 20 percent to 50 percent was to offset the overall effect on private philanthropic support of the removal of the "unlimited deduction" provision. The unlimited deduction, first enacted in 1924, allowed donors whose charitable contributions over the last ten years have exceeded 90 percent of their taxable net income, to deduct all their contributions for the taxable year without regard to the applicable percentage limitation.

76. Although Rev. Proc. 72-39, 1979-1 Cum. Bull. 818, authorizing reliance on Publication 78, is limited to reliance on the organization's qualification under Int. Rev. Code § 170(c), the authority for the Service's position, § 7805(b), as well as its logic, apply equally to reliance on the classification of the donee as a 50 percent organization.

77. A problem also arises regarding the 30 percent limitation applicable to contributions of capital gain property where the donation of appreciated capital gain property is itself an event requiring the immediate recognition of gain. This problem has apparently been resolved, at least in the case of a contribution of an installment obligation, by an Internal Revenue Service ruling that the contribution, itself a recognition event, did not invoke 30 percent limitation. *See* Rev. Rul. 74-336, 1974 Int. Rev. Bull. No. 23 at 33.

78. *See* H. R. Rep. 91-413 (Part I), 91st Congress, 1st Session 52 (1969).

79. *See* H. R. Rep. No. 91-782, 91st Congress, 1st Session 292 (1969).

80. *See* Treas. Reg. § 1.170A-8(d)(2).

81. Under Int. Rev. Code § 381(c)(19), the carryover of corporate contributions is available to the acquiring or surviving corporation in certain tax free reorganizations and liquidations.

82. *See* S. Rep. No. 830 (Part 2), 88th Congress, 2d Session 213 (1964).

83. S. Rep. No. 830 (Part I), 88th Congress, 2d Session 61 (1964).

84. S. Rep. No. 830 (Part I), 88th Congress, 2d Session 61 (1964).

85. The carryover provisions apply to contributions in excess of the donor's applicable percentage limitation in a given year even though the donor elects the standard deduction in that year. *See* Treas. Reg. § 1.170A-10(a)(2).

86. *See* Treas. Reg. § 1.170A-10(b), Example (1).

87. *See* Treas. Reg. § 1.170A-10(b)(2) and (c)(2).

88. Ibid.

89. *See* Treas. Reg. § 1.170A-10(b) and (c).

90. *See* Treas. Reg. § 1.170A-10(e).

91. *See, e.g.,* Inaja Land Co., Ltd., 9 T.C. 727 (1947). *But see* Taggart, *supra* note 25, at 125, 131.

92. For example, if the property involved had a fair market value of $20,000 and a basis of $10,000, the donor could sell the property to charity for $10,000 cash and recover his cost while giving charity the $10,000 appreciation element. His deduction in such a case was for the $10,000 appreciation element contributed, while the $10,000 realized was treated as a recovery of his basis, thus generating no income.

93. *See* H.R. Rep. No. 91-413 (Part I), 91st Congress, 1st Session 53-54 (1969).

94. S. Rep. No. 91-413 (Part I), 91st Congress, 1st Session 53 (1969).

95. *See* Treas. Reg. § 1.1011-2(b).

96. Treas. Reg. § 1.1011-2(a)(1).

97. Treas. Reg. § 1.170A-4(a).

98. If the property with a fair market value of $20,000 had instead been sold for the donor's basis of $15,000, the donor would have had a gain of $3,750, and a contribution which Int. Rev. Code § 170(e)(1)(A) would reduce to $3,750. The gain, taxable at ordinary income rates, is equal to the amount of the contribution and, assuming that the percentage limitation rules are not invoked, to the amount of the charitable deduction. If the property with a fair market value of $20,000 and a basis of $10,000 is sold to a charity for $15,000, applying the basis allocation first results in a gain of $7,500 and a charitable contribution of $12,500, and applying the reduction rule first gives the donor a gain of $5,000 and a charitable contribution of zero. Again, assuming the percentage limitation does not come into play, the resulting gain net of the deduction is the same regardless of which rule is applied first.

99. Treas. Reg. § 1.1011-2(a)(4).

100. *See* Joseph B. Simon, 32 T.C. 935 (1959), *aff'd,* 61-1 USTC ¶ 9136 (3rd Cir. 1960); First National Industries, Inc., 26 T.C. 136 (1967), *aff'd,* 69-1 USTC ¶ 9145 (6th Cir. 1968), *cert. denied,* 394 U.S. 1014 (1969); *Oates* v. *U.S.,* 69-2 USTC ¶ 9658 (N.D. Tex. 1969). *See also Crane* v. *U.S.,* 46-1 USTC ¶ 9123 (2d Cir. 1946), *aff'd,* 331 U.S. 1 (1947).

101. Treas. Reg. § 1.1011-2(a)(3). *See also* Treas. Reg § 1.642(c)-5(a)(3).

102. Labovitz, *The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements, 3 J. Legal Stud. No. 1 (1974).*

PERSONAL DEDUCTIONS IN AN IDEAL INCOME TAX

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Tax expenditure analysis has shown that deductions and exclusions are inferior devices for implementing nontax policies. In this article Professor Andrews agrees that it is useful to evaluate departures from an ideal income tax as tax expenditures, but maintains that the ideal for this purpose must be carefully stated and worked out to embody the intrinsic objectives of the tax. Starting from a formulation by Henry Simons, Professor Andrews argues that an ideal personal income tax is one in which tax burdens are apportioned to a taxpayer's aggregate personal consumption and accumulation. Then, focusing on the consumption component of the tax base, he examines two provisions of the present tax law—the medical expense deduction and the charitable contribution deduction—and contends that there are persuasive reasons why the concept of personal consumption for tax purposes should be elaborated in a way that excludes medical services and whatever satisfactions one gets from making charitable contributions. Finally, Professor Andrews explores some of the implications that his analysis has for other aspects of personal income taxation.

A variety of provisions in the income tax law are now described as tax expenditures and evaluated as if they involved direct government expenditures equivalent in amount and distribution to the revenue reduction they produce.[1] The medical expense deduction, for example, is described as the equivalent of a direct expenditure program by which the federal government provides partial reimbursement for extraordinary medical expenses.[2] So viewed, of course, the provision seems to reflect an upsidedown idea of policy because the rate of reimbursement is the taxpayer's marginal tax rate; this results in relatively generous rates of reimbursement for the well-to-do, while it provides nothing at all for the very poor who presumably have the greatest need.

Similarly, the charitable contribution deduction has been described as a kind of government matching gift program for the support of taxpayers' charities.[3] Again the distribution of matching grants is effectively skewed to favor the charities of the wealthy because of their higher marginal tax rates: in the 70% bracket, for example, the Government contributes $70 to match the taxpayer's $30 contribution, while in the 20% bracket the Government's matching grant is only $20 for each $80 contributed by the taxpayer. Furthermore, there are other difficulties. Presumably, we would not permit direct government expenditures to provide matching gifts for churches. And if we were to have programs of direct support for other charities, it seems likely that we would insist upon a much more rigorous evaluation of priorities than the tax expenditure mechanism provides.

These are devastating criticisms. If they are correct, it seems to me the provisions in question are indefensible. But my feeling is that the criticisms are somehow overstated and that more sense can be made out of these two provisions than tax expenditure analysis immediately indicates. To be sure, there are other provisions of the tax law, like the exclusion of municipal bond interest, with respect to which I think the tax expenditure analysis is completely valid. But its application to the medical expense and charitable contribution deductions seems to me somehow to miss the mark.

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The principal lesson to be derived from the tax expenditure analysis, I think, is that deductions (or exclusions) in the individual income tax are inferior devices for implementing objectives extraneous to those of the tax itself. This is mostly because of graduated rates. It will not generally make sense to distribute government funds according to the graduated rates in the personal income tax unless the purpose of the distribution is intrinsically related to the distribution of tax burdens that those rates are designed to effect.[4]

But this lesson makes it imperative to focus very carefully upon the question whether the purposes underlying a particular provision are indeed extraneous to the purposes of the tax. Put the other way, it makes it imperative to consider carefully whether a provision can be defended by reference to intrinsic matters of tax policy before evaluating it as if it were something else. The tax expenditure analysis itself does not lead us to focus on that question because characterization as a tax expenditure and analogy to a direct expenditure generally imply that the provision serves purposes outside those of the tax system. The crucial judgment about underlying purpose tends, therefore, to get made by implication when a provision is classified as a tax expenditure, before the analysis itself begins.

If we look back at the basis of classification utilized by the tax expenditure analysts, we find that any provision which exempts or otherwise treats income differently on account of its particular source or use is classed as a tax expenditure.[5] The underlying assumption is, in effect, that an ideal personal income tax would apply comprehensively and without exception to all income whatever its source and however it is used, and that any departure from that norm must be justified, if at all, by reference to extraneous purposes. But analysis in terms of tax expenditure has made that assumption too important to accept without critical reexamination.

I agree that in the end it is useful to speak in terms of an ideal income tax and to evaluate departures from the ideal as tax expenditures whose purposes, not being reflected in the ideal, must be extraneous to those of the tax.[6] But the ideal for this purpose must be carefully shaped and refined to reflect the intrinsic objectives of the tax. The unelaborated simple idea of a comprehensive tax on all income without distinctions of source or use is a good starting point and a useful touchstone for identifying particular provisions to be discussed, but it must be regarded as tentative and subject to refinement. The tax expenditure analysis makes the precise content of the ideal too important for us to be able to accept any general, a priori definition as a final formulation.

Approaching the problem from the standpoint of any particular provision, therefore, the question that the tax expenditure analysis makes it urgent to consider is whether the provision can intelligently be seen as reflecting a refinement in our notion of an ideal personal income tax, rather than a departure from it. Only if that question is answered in the negative can the provision be adequately evaluated as if it were a direct expenditure unrelated to the collection of taxes.

These considerations have led me to reexamine the content of our notion of an ideal personal income tax in relation to the question of personal deductions to try to see whether, and under what conditions, deductions can be regarded as refinements instead of departures from the ideal. This paper sets forth the results of that reexamination, first in general terms and then in specific relation to the medical expense deduction and the charitable contribution deduction. Finally, there is a brief indication of some of the implications the analysis may have for other issues.

In general I will argue that an ideal personal income tax is one in which tax burdens are accurately apportioned to a taxpayer's aggregate personal consumption and accumulation of real goods and services and claims thereto—the uses to which income is typically put rather than the sources from which it is derived. This formulation is suggested by Henry Simons' definition of personal income as the sum of personal consumption and accumulation.[7] More importantly, it is consistent with the primary, intended, real effect of the tax, which is to reduce private consumption and accumulation in order to free resources for public use. The practical operating base on which the tax is computed consists of income transactions, but the ultimate object of the tax is to lay a uniform graduated burden on aggregate consumption and accumulation.

This formulation of an ideal does not provide clear or easy answers to all specific questions of income determination because it incorporates the ambiguities implicit in the concepts of consumption and accumulation. Consumption in particular is not a self-defining term. In practice we start from a tentative definition that includes whatever people spend their money for. However, that is only a convenient starting point from which to try to move toward a more refined concept defined ultimately in terms of real goods and services. To make taxable income conform with this more refined concept ideally requires, as Simons clearly recognized, an addition to cash income for goods and services included in the refined consumption concept but not purchased.[8] It also requires, though this has not been so widely recognized, a deduction for expenditures for items not included either in the refined consumption concept or in accumulation. The central question about any particular deduction provision is whether there is good reason, in refining the concept of personal consumption as a component of taxable income, to exclude the particular goods or services for which the deductible expenditure is made.

Thus, in evaluating the medical expense deduction the underlying question is whether medical services should be included or excluded in the refined concept of personal consumption for tax purposes. For many purposes, of course, medical services are properly classed as personal consumption. But for purposes of interpersonal comparisons of taxable capacity there are persuasive reasons for excluding medical services. As between two people with otherwise similar patterns of personal consumption and accumulation, a greater utilization of medical services by one is likely not to reflect any greater material well-being or taxable capacity, but rather only greater medical need. Ultimately the question of excluding medical services from the tax base is a question of judgment. But there is a rational argument to be made for it, in terms that are quite germane to the elaboration of an ideal personal tax base, not extraneous objectives. This is the basis on which the medical expense deduction should be primarily evaluated.

Evaluating the charitable contribution deduction is considerably more complex. Should personal consumption, as a component in our base for distributing or allocating income tax burdens, reflect the provision by churches, schools, museums, and other charities of collective goods and services financed largely by voluntary contributions? And if so, how can the value of such goods and services be measured and on whose return should they be reported—the recipient of the services or the contributor who pays for them? In the case of many charitable contributions the material goods or services purchased with the contributed funds inure entirely to the benefit of persons other than the donor, and the donor enjoys only the nonmaterial satisfaction of making a gift. Even in the case of charities like churches which provide some service to their donors, the benefits received by the donor have many of the marks of free or collective goods, which are generally not reflected in our tax base. In the case of food, clothing, housing, and other divisible goods the price system operates to make what one pays an accurate measure of what he gets. Therefore, a tax on income spent for these items will be apportioned in fair relation to consumption. But in the case of collective goods financed with contributions there is no such correspondence between what one contributes and what he receives.

A good argument can be made that taxable personal consumption should be defined to include divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is nonpreclusive or the nonmaterial statisfactions that arise from making contributions. Whether to accept this argument and where to draw the required lines are matters of policy choice and judgment rather than logical demonstration, but again the question is one that is intrinsic to the elaboration of an ideal personal tax base. It is primarily on this basis that the charitable contribution deduction should be evaluated.

In summary, there are substantial arguments in favor of both these personal deduction provisions that are intrinsic arguments of tax policy germane to the basic question of how to achieve a fair distribution of personal tax burdens. Moreover, these are arguments that illuminate the concept of an ideal personal tax base, as well as the particular deduction provision in question, and make the elaboration of the former bear on the evaluation of the latter and vice versa.

The concept of an ideal personal income tax base developed here, while derived in part from Henry Simons' formulation, is admittedly different from the common interpretation of his position. The common interpretation would include in the base all income from any income-producing activity, whatever it may be used for. The statement that income equals consumption plus accumulation is interpreted not as a definition of income but rather as an accounting identity between different and in some respects opposite things, somewhat like the statement that assets equal liabilities plus net worth. The terms of the identity have to be interpreted consistently to make it hold, but the identity is no more a definition of income in terms of consumption and accumulation than it is a definition of consumption in terms of income and accumulation. And Simons himself, though he offered the identity as a definition of personal income for tax purposes, did not draw the conclusions from it that are set forth in this paper.[9] All he meant, at least some would say, was that gain or accretion is to be included in the tax base whatever its source, and whether it is spent or saved.[10]

In the end, therefore, the position taken in this paper can be more clearly expressed by a substitution of terms than by a definition of income. Instead of saying income means consumption plus accumulation, let us say directly that an ideal personal income tax is one in which tax burdens are accurately apportioned to aggregate personal consumption plus accumulation. A personal income tax is computed on the basis of income transactions, but ultimately its fairness depends on how well taxable income can be made to reflect a refined conception of aggregate personal consumption plus accumulation. This paper is an exploration of the reasons for that ideal and its implications, particularly in relation to the personal deductions for medical expenses and for charitable contributions.

Again, the statement that an ideal income tax would be one apportioned to aggregate personal consumption and accumulation does not resolve all particular questions of personal income determination. But it does specify what the real problems are—namely, those that have to do with ambiguities and refinements in the notions of personal consumption and accumulation. And those are precisely the problems dealt with by the personal deduction provisions.

On the other hand, the statement does reveal that many distinctions are irrelevant to an ideal personal income tax—namely, those that have no relation to the measurement of personal consumption or accumulation. In general, distinctions based on sources of income do not reflect differences in consumption or accumulation.[11] Indeed, that was Henry Simons' main point, that the personal income tax should be purged of source distinctions.[12] Provisions that draw such distinctions do have to be justified, if at all, by considerations extraneous to the central purpose of a personal income tax, and it is therefore perfectly appropriate to evaluate them as if they had been cast in the form of direct expenditure programs.[13]

The concept of an ideal personal income tax developed here has relevance for a variety of concrete issues other than the medical expense and charitable contribution deductions, but these lie essentially beyond the scope of this paper. In particular, it has implications for the question whether we should have graduated personal taxes tied more closely to aggregate personal consumption expenditures alone instead of total income or accretion.[14] The argument here is that, whether we ultimately decide to tax consumption plus accumulation or only consumption, it will be useful to view the tax as fundamentally a tax on uses to which income is put. If that view is taken, it places the choice between taxing consumption and taxing total accretion in a new light because, from the point of view of use of resources, accumulation is in some respects just the opposite of consumption. Furthermore, if we can learn to see the personal income tax as an indirectly measured tax on uses of resources, the shift toward a more explicitly consumption-oriented tax may appear much less radical than it is commonly assumed to be.

Nevertheless, an examination of the question whether ultimately to try to apportion taxes to current consumption or to total accretion is beyond the scope of this paper. That question has to do with the accumulation component of total accretion, and requires an examination of the relation between accumulation and consumption and of the implications of combining or separating the two. This paper has to do with the simpler question of specifying what should be included in the current consumption component of the tax base, whether or not accumulation is also included.

I

AN IDEAL PERSONAL INCOME TAX

Specification of an ideal personal income tax base often takes the form of a definition.[15] An ideal personal income tax would be one under which all personal income is taxed, uniformly and comprehensively. It therefore remains only to define what constitutes personal income in order to know what an ideal personal income tax base would be.

Definition, of course, should not be mistaken for demonstration; definition indicates only the meaning being assigned to the term defined. Nevertheless, I propose to follow precedent by starting with an exploration of the meaning of the term income, not because it demonstrates what an ideal personal income tax base would be, but because it does expose the principal possibilities and their interrelationships. Moreover, a discussion in terms of meaning provides some suggestion of how thought on the subject may indeed have evolved.

The Meaning of Personal Income

Personal income is a complex concept whose meaning includes several overlapping strands. In particular, at least four senses of the term may be relevant to its use as a tax base: (1) income as regular, recurring cash receipts; (2) income as compensation for services or use of capital or both combined, in whatever form received; (3) income as net accretion in whatever form received and from whatever source; and (4) income as aggregate consumption plus accumulation of real goods and services or claims thereto—income as the determinant of one's standard of living—whatever its source.

To a large extent these senses overlap, representing different aspects of the same thing. Money income is both what one receives as compensation for services or return on capital investments and, typically, the medium of exchange through which one commands private goods or services for consumption or accumulation. Money income is what one gets for his participation in the production sector of the economy and also is the measure of his entitlement to participate in the distribution sector. Indeed, it is these relations among different aspects that make income an interesting and powerful unitary concept.

But the overlap of meaning is not complete. There are many instances of services compensated otherwise than with money or not compensated at all, and of goods and services consumed without the expenditure of money or the provision of services or any other explicit exchange. The treatment of these instances is crucial to the elaboration of an actual income tax base, and seems to require an attempt to determine which sense or senses of the term should control when their application to particular items does not produce consistent results.

1. *Money Income.*—Income in the sense of recurring cash receipts from a regular source or a reasonably limited number of definite, ascertainable sources is the practical base on which income taxation is built. However the term may be refined, the fact that income is reflected to a large extent by cash receipts from sources which can be satisfactorily identified and audited is what makes an income tax possible. Indeed, what makes a mass income tax feasible is the fact that for many taxpayers income is adequately represented by cash payments from a single source, the taxpayer's employer, who can be pressed into service as collector of the tax through withholding. Whatever refinements of the concept of income may be proposed, practical considerations absolutely require that this primary tie to cash receipts as a base be recognized and preserved.

However, it has apparently never been thought that money income, as such, would serve as an ultimate ideal of a personal tax base. Income is to be taxed *in whatever form received.*[16] Money income in some sense represents or stands for something else; and the tax is ultimately to be apportioned according to that something else. A tax that rested ultimately on money income as such, without refinement, would be too easy to defeat in many situations by the institution of barter exchanges or other forms of realization in kind.

2. *Income as Compensation for Services or Use of Capital.*—Money income is ordinarily received for the performance of services or the investment of capital in productive enterprises, or for both combined in the case of direct operation of a business enterprise. Money income is primarily what one is paid for his participation in the production sector of the economy. In going beyond or behind money income in its simplest sense to the thing it stands for, therefore, one comes naturally to the notion of compensation for services and return on capital investment. One might say, accordingly, that income is to be defined for tax purposes as compensation for services or return derived from capital or from labor and capital combined, in whatever form realized.[17]

Functionally, this definition of the term income would require that we begin with money income and then add something for compensation for services or return on capital investment received in any other form. It would also suggest that cash receipts should be excluded if they do not represent compensation for services or return on investment. Gifts and prizes for which one does not compete, for example, may not represent compensation for services. But in this respect this sense of the term income has come to seem to restricted to serve as an ultimate ideal for a personal tax base. There is no reason to exclude a gain or receipt from taxable income solely because it represents a windfall rather than compensation for services or use of capital;[18] a gain is no less spendable for food or entertainment or anything else because it is unearned.

In fact, income as compensation for services or return on capital, in whatever form received, has continued to be an influential idea in shaping the income tax;[19] but it has been generally rejected as an ultimate specification of an ideal personal tax base.

3. *Income as Accretion.*—Rejection of any kind of source limitation brings us to Haig's conclusion that, ideally, taxable income should be defined as gain or accretion, in whatever form received and from whatever source derived.[20] But accretion is a very abstract idea that "does not go far to describe its content in relation to particular problems of income determination."[21] What is gain or accretion and how is it to be identified if not either by source of gain or form of receipt? Does it include accretion to a poet's reputation, to a politician's power, to a young man's professional prospects?

4. *Income as Consumption Plus Accumulation.*—To give more specific content to the notion of accretion, Henry Simons advanced what is now the most widely accepted definition of personal income for tax purposes, defining it not in terms of sources but of uses. In its oft-quoted long form the definition states:[22]

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.

In its short form, as Simons repeated it throughout his book, income is consumption plus accumulation.

Simons' definition makes distinctions among sources of gains or receipts irrelevant, since a dollar will support the same amount of consumption or accumulation whether it comes from labor, dividends, municipal bond interest, gambling, or oil. To repeat, the irrelevance of source distinctions for income tax purposes was Simons' main point. His major practical proposals for change in the income tax had to do with the elimination of favored treatment of items like municipal bond interest[23] and capital gains;[24] and he even urged inclusion of gifts and bequests in the taxable income of the recipient.[25]

Insofar as either Haig's or Simons' definition eliminates source distinctions it simplifies the concept of income. But Simons' definition literally imports into the definition of taxable income all the ambiguities implicit in its own terms, consumption and accumulation. The notion of personal consumption, in particular, might theoretically be expended almost indefinitely to include a variety of fringe benefits and items of imputed income which it would be wholly impractical to try to reflect directly in any operational definition of taxable income. Consequently, to give his definition practical, operative content, a sensible line must be drawn indicating what to include in the category of consumption.

Simons saw this problem clearly. Indeed, it would be hard to improve on his lucid discussion of consumption income in kind.[26] Income should be defined, he wrote, to include substantial fringe benefits provided in kind which a taxpayer would otherwise have to purchase out of after-tax income. But with respect to some items, particularly in the entertainment category, there is an insuperable problem of valuation, especially when such benefits serve mixed compensatory and business-promotional objectives. Often nothing in the situation gives any sure indication of how much, if anything, the recipient would have paid for the benefit if it had not been provided in kind. Simons recalled Kleinwächter's conundrum of the *Flügeladjutant* to the prince whose duty was to accompany the prince to the theater and operas, to banquets, and on hunts. Should he be taxed on the value of his horses, food, and entertainment; and if so, how much? And suppose, "as one possible complication, that the *Flügeladjutant* detests opera and hunting."[27] A more current example would be the businessman whose work takes him to Europe twice a year. How are we to ascertain in such a case whether foreign travel is a boon or a burden?

The problem can be restated, though hardly resolved, in terms of a distinction between ultimate consumer goods and services and intermediate goods or services which are produced as a step toward production of something else.[28] The question then is whether the businessman's travel is an ultimate good or a step in the production of other things—whether he travels to earn his income or whether he works partly in order to travel. Putting the problem this way does not resolve it, however, because motives are often mixed or hard to ascertain or both.[29]

The problem of distinguishing ultimate from intermediate goods does not arise solely because employers provide benefits in kind, but rather because of the necessity of assessing what is required to get a particular job done. An employee may be required, for example, to travel or entertain for reasons related to business, but at his own expense; and then the issue will not be whether to include a noncash item in his income, but whether to allow a deduction for his expense. In either event, however, the underlying inquiry is the same—whether the travel or entertainment in question should be treated in effect as a taxable item in the consumption component of the employee's income. The deduction serves as an adjustment to get from cash income to taxable consumption when some money income has been spent on an item not intended ultimately to be taxed.

Beyond fringe benefits there are all sorts of items of imputed income that could be taken into account. Most importantly the consumption return on owner-occupied housing, and perhaps some other high-value consumer durables, should ideally be included in income.[30] There is also a substantial element of imputed income in the performance of housekeeping and other services for consumption in kind within the household. Indeed, even leisure is an element of imputed income in the consumption category since it too represents an alternative use of time and energy, which are themselves scarce economic resources.[31]

Simons did not assert that all these items should be included in taxable income. Neither did he suggest that there is any easy way to sort out what should be included from what should be ignored. These are difficult problems in which competing considerations of fairness and practicality must be continuously weighed against one another. Compromises must be worked out, trade-offs must be considered. With respect to imputed income from owner-occupied housing, he concluded it should be taxed, notwithstanding the valuation problems involved, because it is a substantial item and one that varies considerably in value among different households.[32] With respect to services produced and consumed within the household, he concluded that these could be left out of account in practice because of the immensity of the valuation problems involved and because disparities in the distribution of such services among households at any particular income level could be assumed to be less substantial.[33] In addition, he pointed out that the omission of leisure from the tax base is largely an offset to the omission of services performed within the household, since to the extent one performs such services he sacrifices his leisure and vice versa.[34]

Of course, some households have less of their members' time to devote to either leisure or household services because more is taken up with employment outside the home. It would probably not be practical to try to measure and value such differences in available time directly. But it would be possible to reflect them roughly and indirectly by reinstituting an earned income credit under which earned income would be partially omitted from the tax base. On its face an earned income credit looks as if it introduces a source distinction into the income tax. However, it might actually be the most practical way there is to provide some reflection of differences in use of time and energy between people who work for their income and those who do not. Simons seems to have favored the idea of an earned income credit, although it was not one of his central concerns.[35]

In relation to these problems the concept of consumption is not one that enters into Simons' definition of personal income with a simple, fixed, or predetermined meaning. It is rather a concept calling for creative elaboration to effectuate the practical implementation of the purposes of the tax. If Simons' definition of personal income were intended only to settle meaning and eliminate ambiguity, it would have to be rated a failure since the ambiguities implicit in consumption (and accumulation) are no less than those implicit in the term income itself. But Simons' definition indicates the direction in which meaning should be elaborated and where the real problems of tax policy are to be found. What is important about money income for tax purposes, Simons' formulation indicates, is not so much that it reflects one's participation in the production sector, but that it determines his participation in the distribution sector. And when we say income is to be taxed in whatever form received, it is the latter relation, not the former, that we should seek to refine. If a taxpayer's contributions in the production sector are more or less than what he is paid, it really does not matter; he should be taxed on what he is paid anyway. But if a person's money income fails to give a fair general measure of his participation in the distribution of real goods and services, then we must consider how great the disparity is and whether there are practical ways to adjust for it. Hard policy problems do not have simple answers. Simons cannot tell us in advance just what has to be taken into account, and how to make taxable income as fair and practical as possible a reflection of aggregate consumption and accumulation, but he does tell us that this is the problem to which we should address our efforts.

Simons' definition in principle requires that if a taxpayer's consumption includes substantial items not paid for, these should be added to money income. On the other hand, if his consumption and accumulation of real goods and services (or claims thereto) is less than his money income, for whatever reason, in any substantial and ascertainable way, then under Simons' definition that discrepancy should be adjusted for by a deduction from money income. Thus, if a taxpayer pays for travel or entertainment that does not represent consumption to him because it is only a means of getting his job done, he gets a business deduction. But the same principle is applicable to any other expenditure that does not represent personal consumption or accumulation, whether or not it is business-connected.

This last implication has not been generally recognized. Simons himself did not develop or even clearly admit it. There is a tendency to continue thinking of income in terms of income-producing transactions and, therefore, to think that net income once earned and received is income whatever is done with it.

Thus Simons' identity can be satisfied (in this respect) by including in consumption anything one spends his money on, except for the production of more income.[36] But either that thought is circular since it effectively defines consumption in terms of income or it represents reversion to other senses of income—income as cash receipts or income as compensation. If we take literally Simons' specification that income is to be defined in terms of consumption and accumulation, then a deduction should be allowed whenever money is expended for anything other than personal consumption or accumulation. And that, arguably, is the intrinsic role of personal deductions.

The Purpose of a Personal Income Tax

Identification of an ideal personal tax base as aggregate personal consumption plus accumulation makes good sense in terms of the purpose and effect of a personal tax. The primary intended effect of a direct, personal tax must be to divert economic resources away from personal consumption and accumulation. Some part of the national output which would otherwise be consumed or accumulated by private individuals is to be devoted to public purposes. Government expenditures are the device by which particular goods and services are devoted to public use, and taxation is the mechanism for imposing and distributing the corresponding reduction in private consumption and accumulation which must accompany the commitment of part of the aggregate national product to public purposes.[37]

If the primary intended effect of the tax is to cause a reduction of private consumption and accumulation of real goods and services, then it makes sense to distribute the reduction in some kind of uniform (though graduated) relationship to the amount of consumption and accumulation people would otherwise enjoy. The effect of imposing direct personal taxes on the basis of aggregate consumption plus accumulation is to treat all people at any particular level of consumption and accumulation alike without regard to differences in the means by which their consumption and accumulation are financed. The result is that people at any given level of consumption plus accumulation before the tax will remain at the same level as one another after the tax, having borne an equal reduction by reason of the tax.

This is all equally true, perhaps even more clearly so, if we think part of the purpose of a graduated income tax is relative redistribution. What we mean to redistribute, ultimately, must be shares of real goods and services which persons otherwise would be consuming or accumulating; the disparities we mean to mitigate are disparities in aggregate distributive shares of real goods and services, whatever the form and source of those disparities. Accordingly, it makes sense to try to define taxable income to provide as refined a reflection of aggregate real consumption and accumulation as it is practical to achieve.

There is a more familiar way of stating the purpose of the income tax that may seem to point in a somewhat different direction: taxes are to be levied according to ability to pay, and such ability is shown by the receipt of income whether or not it is devoted to personal consumption and accumulation. But ability to pay expresses only a most vague and general idea of tax policy.[38] It expresses a rejection of a benefit approach in which one tries to assess taxes in relation to the distribution among taxpayers of the benefits of government services. But it hardly goes any further because it fails to specify how ability is to be measured. There is no warrant for an a priori assumption that money income without adjustments is an ideal index of ability.

One way to measure ability to pay taxes is in terms of aggregate personal consumption and accumulation because this is what it is assumed will ultimately be sacrificed to pay the tax. Another way is in terms of power or wealth, including personal earning capacity, because to the extent a man has power in excess of his personal consumption and accumulation he can pay the tax without curtailing them. A tax on wealth, including earning power whether exercised or not, would have the further advantage of being neutral with respect to taxpayers' choices between work and leisure, thus leading in theory to the most efficient allocation of time and energy between the two. But is it feasible to get a satisfactory index of power in this broader sense? And what adjustments in taxpayers' affairs would imposition of such a tax require? Unexercised earning power is a source of ability to pay, but it would be very difficult to measure. Moreover, it is not clear we would want an income tax that would compel people to take higher paying jobs than they would otherwise choose in order to raise the funds to pay the tax. But if we do not tax a man on what he declines to earn, then why should we tax him on what he does earn but does not devote to his own personal consumption or accumulation?

The Strategy of Personal Income Taxation

An ideal base for distributing personal tax burdens may be aggregate personal consumption plus accumulation of real goods and services. But it is not feasible to measure that quantity directly. We rely on money expenditures to provide a practical measure of the real consumption and accumulation which such spending buys. However, it is not practical to record and audit even personal expenditures directly. Consequently, we rely on the long run equivalence between money income and money expenditures for consumption and accumulation and compute the tax on the basis of the former.

The strategy of personal income taxation is to take money income as a readily ascertainable starting place, knowing that money income is either spent or accumulated and that money expenditures provide a measure of total consumption plus nonmoney accumulation. Then such adjustments are made as are practical and desirable to achieve a more refined reflection of aggregate real consumption and accumulation. Indeed, in practice the starting point is money income from a limited number of sources, even though in the end we do not think differences in source merit differences in tax treatment. For many taxpayers the computation of taxable income begins and ends with money income received by the taxpayer from his employer, and the tax is primarily collected by withholding from salaries and wages. But additions are made for cash receipts from other sources as well, and for a limited number of noncash receipts. Ideally we might find reason to make a great many more adjustments than we do. Real problems of tax policy present and turn on the continuing resolution of the endless conflict between realization of the ideal of a uniform reflection of aggregate real personal consumption and accumulation and the practical necessity of keeping the computation of taxable income sufficiently near to its money income base.

In this description of the strategy of income taxation, earlier senses of the term income have not been discarded after all. Money income from employment and investment remains the primary base on which the income tax is to be computed. Aggregate personal consumption plus accumulation is not the computational base but rather the ideal toward which the computation should point. The strategy of personal income taxation depends upon the relations among earning and spending and saving, in somewhat the same way that the full meaning of the term income embraces the several ideas of cash receipts, earnings in any form, and disposable income whatever its source. This richness of reference is not revealed by a declaration of tax policy in terms of any single-valued definition of personal income.

Since multiple meanings are involved, the matter may be more clearly put by using several terms. Let income retain only its most common senses: money income or net return from services or capital investment. An income tax is then any tax computed and collected on the basis of income transactions as commonly understood. But our object in designing the tax is to make it impose a uniformly graduated burden on aggregate personal consumption plus accumulation. The personal income tax is thus an indirectly measured tax on aggregate personal consumption and accumulation. Income transactions provide the practical basis for computing and collecting the tax, but aggregate personal consumption and accumulation are its real objects.

This makes it explicit that while the computation and administration of the tax will center around income transactions as commonly understood, consumption and accumulation describe the goal or ideal toward which the practical computation should be directed. The fact that consumption is itself a term full of ambiguities, perhaps more than the term income, should not bother us much in this context. Purposes are often expressed in vaguer terms than the concepts used for implementation. Putting the matter this way will also leave us freer to elaborate the notions of consumption and accumulation as ultimate objects of personal taxation, unembarrassed by any implicit limitations which they may assume when used in a definition of income. In some respects consumption, at least, is just the opposite of income; and the definition of one in terms of the other may tend to obscure relevant features of both terms.

This way of thinking about the income tax, as an indirectly measured tax on something else, should not be unfamiliar. Taxes are often laid on one set of transactions, or even parties, as a way of getting indirectly at something else. Sales taxes are collected from sellers on the basis of their receipts, but are commonly thought to be shifted to purchasers and to constitute ultimately and intentionally a burden on consumption by the purchasers—or on consumption and investment if there is no exemption for capital goods.[39] Perhaps a closer analogy in some respects is the gasoline tax, which is easily seen as an indirectly measured tax on highway use. It would be totally impractical to try to charge tolls directly for all use of public highways. But it is quite practical to tax gasoline sales, which provide in turn quite a good initial gauge of highway use.[40]

From beyond the realm of taxes (as such) it may be helpful to consider the problem of the ski area operator. On many mountains it would be impractical to try to charge skiers directly for their downhill runs. But every ski area operator knows the easy answer to that problem—charge them for riding up the lift. Indeed, it is quite feasible, if one wishes, to charge each skier rather accurately for his aggregate amount of downhill skiing, measured vertically, by reason of the equivalence over time between ascent on the tow and descent on the hill.[41]

At one ski slope in Vermont there is a sign next to the tow proclaiming that the skiing is free. People sometimes talk about the personal income tax as if it imposed no burden on consumption because it leaves people free to do as they wish with their income. The two ideas are analogous—and similarly revealing. What makes it possible not to charge for skiing as such is the technological superiority of the ski lift, the fact that no one can ski much without riding the lift. Similarly, what makes the personal income tax a feasible, general, personal tax is the relative advantage of specialization, the fact that a substantial and representative portion of economic activity involves a separation between production and consumption in which persons sell specialized inputs in order to purchase their share of the output of the organized production sector of the economy. This is what makes income work as an index of aggregate personal consumption and accumulation. Indeed, it is precisely those areas of economic activity that do not involve a separation and exchange relationship between production and consumption—instances where participants in a productive enterprise consume part of the output directly, or where production occurs for consumption in kind within the household—that present some of the most intractable, intrinsic difficulties in the subject of personal income taxation.

The Role of Personal Deductions

The adjustments by which taxable income can be made to give a more refined reflection of aggregate personal consumption and accumulation may be positive or negative. If a substantial item of personal consumption is enjoyed without any cash expenditure, then the appropriate adjustment is to add the value of that item to money income. On the other hand, if the concept of consumption is elaborated in a way that does not include some items for which money is spent, then the appropriate adjustment is to deduct the amount of those expenditures from money income. The appropriate role of personal deductions in an ideal income tax base is just that—to adjust for discrepancies between money income and real consumption and accumulation resulting from expenditures for items that we do not wish to take into account as part of the aggregate personal consumption or accumulation we wish to tax. Personal deductions in the income tax thus perform a function like that of refunding gasoline taxes for gasoline not used on public highways.

This justification for personal deductions may be resisted on the ground that whatever one chooses to spend his money for, except as part of the cost of earning more, should be classed as personal consumption. For other purposes this is probably an appropriate notion. In particular, for purposes of describing and analyzing allocation and distribution of resources in an organized exchange economy, it is more convenient to treat any utilization of final products for which people will pay as constituting consumption. In effect, the accounting identity between income and consumption plus accumulation is satisfied by making consumption conform to ordinary notions about what constitutes income, and the identity functions largely as a definition of consumption.

But Simons told us to define taxable personal income in terms of consumption and accumulation. Surely it is now circular to define consumption in this context, except provisionally, in terms of use of money income. It is undoubtedly prudent as a matter of tax policy to follow that definition as a general rule, with few exceptions, since money expenditure is by far the best available means of measurement. But if we take it seriously that the ultimate purpose is to apportion tax burdens in uniform, graduated relation to real consumption and accumulation, then we must be willing, in principle at least, to consider whether there are some expenditures for which a deduction should be allowed because the concept of consumption can be better elaborated as part of an ideal tax base if the item purchased with the expenditure is excluded than if it is included.

In the case of the medical expense deduction, for example, we must address ourselves to the question whether there are persuasive reasons why the concept of personal consumption for tax purposes should be elaborated in a way that excludes medical services. Similarly, in the case of the charitable contribution deduction, the ultimate question is whether there are persuasive reasons for leaving out of the personal tax base whatever satisfactions one gets, directly or indirectly, from making such contributions. We are now ready to take up those two questions in greater detail.

II

THE MEDICAL EXPENSE DEDUCTION

Since 1942 our income tax law has allowed a deduction for medical expenses.[42] Today the deduction is generally available for uncompensated medical expenses in excess of 3% of adjusted gross income and to a limited extent for medical insurance premiums without regard to the 3% floor.[43] A deduction for medical expenses is claimed on about 37% of all returns, or 77% of all returns with itemized deductions.[44] The total amount of the deduction claimed on all returns in 1970 was $10.6 billion, 1.7% of total adjusted gross income for that year.[45] The total reduction in taxes resulting from the deduction has been estimated at $1.9 billion per year,[46] or about 2.2% of total personal income taxes.[47] The medical expense deduction is a higher proportion of adjusted gross income for low income taxpayers than for high bracket taxpayers, although the average dollar amount of deduction per return is somewhat more for high income taxpayers.[48]

The medical expense deduction has been called a tax preference, and the reduction in tax liabilities it produces is commonly listed as a tax expenditure.[49] The notion is that the tax law is merely being used as a device to provide partial reimbursement of medical expenses. Viewed in this way, of course, the deduction appears to represent a perverse means of distributing government funds since it has the effect of reimbursing a higher percentage of medical expenses for wealthy taxpayers than for poor taxpayers, who presumably have the greater need.

But this analysis is inadequate. Essentially, it assumes away the best reasons for the deduction by taking a tax on income without a medical expense deduction as its norm and asserting that any departure from that norm must rest on purposes extraneous to those of the tax. I believe we can come to a better understanding of this deduction, and of what an ideal personal income tax would be like, by asking whether there are good, intrinsic reasons for elaborating the notion of taxable consumption—the consumption component of taxable personal income—in a way that excludes medical services, so that the medical expense deduction is a device for approaching the ideal, not a departure from it.

As a preliminary matter it is instructive to try to make more explicit the content of the tax expenditure analysts' norm from which the medical expense deduction is supposed to represent a departure. For a taxpayer who pays for his medical services the norm is cash income from whatever source, without exception on account of its use to pay medical expenses. But when medical services are provided without payment the matter is less clear. In the case of medical services provided as an employee fringe benefit, their exclusion from taxable income is classed as a tax expenditure;[50] the norm would include such services in taxable income. In the case of medical services provided by charity or by government welfare programs, however, failure to tax the recipient has not been listed as a tax expenditure. Nor has it been considered to be a tax expenditure when a tort victim goes untaxed on the value of medical services provided or reimbursed by the tortfeasor. Thus it appears, ironically, that the tax expenditure analysts' norm is one that ultimately includes or excludes the value of medical services according to their source.

Perhaps we should start an examination of this apparent anomaly with the case of medical services provided or paid for by the tortfeasor whose negligence gave rise to the need for care. Should they be included in taxable income, or their omission regarded as a tax preference? Or is the nexus between loss and compensation here too strong? It would seem strange to call the provision of medical services in such a case a windfall since it only serves as a remedy for the injury. The taxpayer is no better off after the whole transaction than before he incurred his injury, and it would be unnatural to view the provision of medical services in isolation from the injury as producing a taxable gain.

Now suppose two taxpayers are injured in an identical manner and treated in an identical manner, but while one recovers the cost of treatment from the tortfeasor who caused the injury, the other has treatment provided by his employer. The second victim is no better off than the first, and it makes no sense to tax him as if he were. To distinguish between these two cases is to introduce a source distinction in which the identical thing is treated differently according to its source and the reason it is provided.

The critical nexus between injury and treatment does not depend on the fact that the tortfeasor provides the treatment, but on the fact that the treatment only puts the taxpayer back where others are who have suffered no injury. If we are willing to say that one has had no taxable gain when he suffers an injury and then receives treatment, we should say it in every case, whatever the source of payment for the treatment—whether or not the tortfeasor pays, whether or not there is a tortfeasor, indeed whether the taxpayer's malady is a traumatic injury or an organic disease.

Finally, consider a third taxpayer with an identical injury who pays for his own treatment. There is no more reason to tax him on the value of his treatment than in the other two cases. But this third taxpayer is worse off than the other two by the amount he has to pay for his treatment. The medical expense deduction, if applicable, will simply reflect that difference.

The Case for Excluding Medical Services from Personal Consumption as a Component of Taxable Income

The medical expense deduction should be evaluated primarily by considering whether there are good reasons to exclude medical services generally from the category of taxable personal consumption. Or perhaps the issue is more clearly expressed the other way around: are there sound reasons to define or elaborate the category of personal consumption, as a component of an ideal personal tax base, so as to exclude medical services?

Medical expenses have many of the typical characteristics of personal consumption expenditures: they represent a utilization of scarce resources; their use is preclusive in the sense that if one person uses up a doctor's time or hospital space, that time or space will not be available to anyone else; medical services represent to some extent an alternative to other uses one may make of his funds; and medical services would seem to be an ultimate product in our economy in the sense that they represent one of the end outputs of the production process, not merely a step in the production of something else. Indeed, from the standpoint of describing the production and distribution of goods and services in the economy, the last point is nearly dispositive. Medical services are one of the important end products of economic activity; their utilization must be described as consumption if consumption and investment are to account for the whole national product.

But the purpose for which personal consumption is used in specifying a personal tax base is not simply to account for the distribution of the national product; it is rather to provide an index of relative material well-being on the basis of which to distribute tax burdens. Such an index may well take account of factors that do not enter into the description of aggregate production and distribution of goods and services in the economy if that will produce a better interpersonal index of material well-being and taxable capacity. In particular, differences in health affect relative material well-being. It would be impractical to try to include robust good health directly as an element of personal consumption for those who have it, but the difference between good and poor health can be partially reflected—or the failure to include the difference directly can be partially offset—by also excluding or allowing a deduction for the medical services that those in poorer health will generally need more of.

Put a slightly different way, medical services are in the end only a means, an intermediate good whose ultimate object is good health. The right basis for making interpersonal welfare comparisons on which to base the distribution of tax burdens is that ultimate object, good health, rather than the intermediate good. Furthermore, it is not expedient to take medical services as a proxy for the ultimate object, good health, because it is not the case, at least between people in otherwise similar financial circumstances, that good health will vary in direct proportion to medical services utilized. If anything, the relation is apt to go the other way.

Of course, many other goods and services purchased by a household could also be seen as intermediate goods for the ultimate production within the household of something else. Flour is only an ingredient for the production of bread or cake. Ascetics might argue that even food consumed is only an intermediate good utilized for the achievement of higher ends. Yet clearly we must base a personal income tax on what a household takes in and pays for, not on any evaluation of what it does with what it takes in. The tax must be laid on the utilization of exchangeable goods and services, at market prices, not on the ultimate satisfactions that particular taxpayers may or may not achieve from them.

But allowing a deduction for medical expenses does not involve us in the difficulties of trying directly to put a price on the enjoyment of good health. The deduction will reflect differences in health only as they manifest themselves in financial terms by requiring substantially different levels of expenditure for medical services. In this respect the deduction treats substantial medical expenses like a loss of earnings. A taxpayer who misses work and loses earnings due to sickness or injury will find his income tax reduced. One who incurs unusual medical expenses, though his salary is uninterrupted, suffers a similar reduction in funds available for other purposes. The medical expense deduction will cause his tax also to be reduced.

What distinguishes medical expenses from other personal expenses at bottom is a sense that large differences in their magnitude between people in otherwise similar circumstances are apt to reflect differences in need rather than choices among gratifications. The distinction holds, to be sure, only as a general matter. First, people may need different amounts of food, for example, because of differences in physical make-up. Yet we do not allow any deduction for food, presumably because we think substantial differences in expenditures for food mostly reflect differences in taste and means. As a further complication, some of the people with a greater need for food may get greater pleasure out of life by reason of their greater appetite or greater size or higher energy levels. It is impossible to make any generalization about whether a large appetite is a boon or a burden, let alone to assign it any monetary value.

Second, particular medical expenses may reflect a considerable component of voluntary personal gratification. It is difficult to find any difference in principle, for example, between expenditures for elective plastic surgery and for cosmetics. But such borderline difficulties are inevitable whatever general policies we choose to pursue. Taxation in particular, like politics in general, is the art of the possible. It seems reasonable to act upon the proposition that disease or injury is a burden, not a boon, and that large differences in utilization of medical services go less than all the way toward offsetting differences in health and need. This is, in any event, the judgment on which defense of the deduction ultimately depends.

There is of course nothing radical about this defense of the medical expense deduction. The point of this discussion is that the defense can be comprehended within the ideal of a tax base consisting of aggregate personal consumption and accumulation, not seen as a departure from that ideal, by recognizing that the notion of consumption as a base for personal taxation may rationally be elaborated differently than it is for other purposes. The ideal will itself be more serviceable if it comprehends arguments such as these, which seem to be so immediately relevant to the question of fair distribution of tax burdens.

A Closer Look at Distribution Implications

The argument for excluding medical services from the tax base is essentially distributional since it depends on a judgment of horizontal equity, a judgment that two taxpayers in otherwise similar circumstances as to consumption and accumulation should be treated and taxed alike notwithstanding substantial differences in their utilization of medical services. Before accepting or rejecting that pivotal judgment, however, a few other distributional comparisons should be considered.

1. *Vertical Equity.*—Differences in utilization of medical services may well reflect differences in need arising from sickness or injury, but they also reflect differences in means. One of the important ways in which the well-to-do are better off than the poor is in being able to purchase more and better medical care. Even if one would agree that a wealthy man in good health is better off than a man with the same earnings but large medical expenses, still a wealthy man with medical expenses is better off than a poor man with the same sickness or injury who cannot afford the same care. Exclusion of medical services from the consumption component of personal income will prevent taxable income from reflecting this aspect of material well-being. Therefore, it may seem that there is a conflict between vertical and horizontal considerations, and that even if the latter might seem to justify exclusion of medical services from taxable consumption, the former requires inclusion.

This apparent dilemma should be of general interest for students of income tax policy. The problem is that *A*, who utilizes medical services in a substantial or unusual amount, is not generally better off than *B*, whose consumption and accumulation of other goods and services is equal in amount but who does not need unusual amounts of medical care; but *A* is better off, by reason of those medical services, than *C*, a lower income taxpayer who is unable to afford such care although he needs it. But if *A* is no better off than *B*, then *B* must be better off than *C* by just as much as *A* is. If *A* is better off than *C* by reason of better medical care, then so is *B*. But *B* has not utilized any unusual or extraordinary amount of medical services.

This is not as strange as it seems. Both *A* and *B* are indeed better off than *C* in relation to medical services because both can afford better medical care if and when the need arises. But the measure of this aspect of welfare—the ability to pay for medical care—is not the amount of medical services actually utilized.

In this respect the availability of better medical care is like a number of other ways in which the well-to-do are substantially better off than the poor, which are not reflected in any practical account of income and expenditures. The well-to-do can afford, for example, to choose jobs from which they derive pleasure and satisfaction, while the less well-to-do may be under greater pressure to take whatever work is available. Similarly, the well-to-do can generally better afford temporary unemployment. A wealthy man who quits his job to look for more satisfying work is not taxed on the salary he could still be making, even though the consumption of time in job hunting is evidently worth at least as much to him as the forgone pay.

It would be impractical to try to make taxable income reflect directly these aspects of welfare which are not given a market value by any personal expenditure transaction. But it is also unnecessary to reflect them directly. At least insofar as we are talking about the ability to afford medical care if needed or to quit an unrewarding job and look for another, it may be reasonable to assume that that ability is roughly a function of wealth or income and that it will be distributed among persons generally in relation to their income, even without any direct reflection of these elements. If that is true, then these elements can be taken into account in fixing tax burdens by the way the rates are set rather than by trying to impute any particular dollar value to them. Indeed, the case for graduated rates might derive some additional support by reference to matters like these.

In general, when considerations of horizontal equity and vertical equity seem to conflict, decisions about the tax base should rest primarily on horizontal considerations, since vertical considerations can be reflected in the rate structure. Put slightly differently, the function of provisions defining the tax base is to place taxpayers in the right order; the question of how much to vary the tax burden for people at different points in the order is a question of rates. Therefore, in the case of medical services it is sound to exclude their cost or value from taxable income if we are satisfied to regard them as an offset to good health as between two wealthy taxpayers, even if availability of better medical services is one of the advantages that does generally go with higher income.

2. Horizontal Equity at Low Income Levels.—The conclusion of the last section can be restated from a different perspective: the exclusion of medical services from taxable income is justified because it will tend to ameliorate the effect of differences in utilization of medical services attributable to differences in health and need for medical services. The amelioration of differences among people attributable to differences in general income level, on the other hand, is primarily a matter of rate structure rather than elaboration of the tax base.

This statement of the matter, however, exposes another difficulty. The allowance of a medical expense deduction does much more to ameliorate differences in need for medical services among the wealthy than among ordinary taxpayers. If public funds are to be spent for relief from the burdens of unusual medical expenses, it would seem they should be spent among the poor where the need is greatest, not among high bracket taxpayers.

But it begs the question to call the deduction an expenditure of public funds. The fact that a provision does more to mitigate differences among wealthy people than among the less well-to-do is simply a characteristic of a graduated rate schedule, whatever may be included in the income tax base. A graduated income tax reduces inequalities of income most among the wealthy, less among those of average means, and not at all among those whose incomes are too low to bear any tax in any event.

If a 70% marginal bracket taxpayer is injured and incurs large unreimbursed medical expenses, the income tax law will soften the blow by giving him a deduction so that his funds available for other consumption uses will be reduced only by 30% of the amount of those expenses. For a 40% bracket taxpayer the blow will be softened less because the deduction will produce a smaller reduction in taxes; he will bear [illegible] of his loss. A 20% bracket taxpayer will bear 80% of his loss. And one who has no income tax to pay anyway will bear his loss in full.

But this effect is exactly the same as the effect on loss of wages. If, as a result of the same accident, a 70% taxpayer lost $1000 of wages, the Government would absorb $700 of the loss. In the case of a 40% taxpayer the Government would absorb $400. In the case of the 20% taxpayer the Government would absorb only $200. For the 0% taxpayer the Government would absorb nothing, leaving the entire loss resting uncompensated on the taxpayer himself.

This lesson is one of general import for students of income tax policy. Insofar as we are concerned, as we must be, with reducing inequalities in income distribution, a progressive income tax is a useful tool, but its usefulness is limited. It is most effective in reducing differences or inequalities in income at the upper end of the income scale. Its effectiveness declines with the rates, however, and it will do nothing to reduce inequality among the nontaxpayers at the bottom end of the income scale. If anything is to be done about inequality at the bottom, it has to be by some form of welfare payment or negative tax.[51]

To be sure, many of the reasons suggested for excluding the value of medical services from the income tax base support the provision of free medical services, especially to the poor, since their validity is certainly not restricted to wealthy people among whom tax relief is most effective.[52] But that does not undermine the argument for excluding the value of medical services from taxable income, whether paid for or not. That argument is not concerned with government provision of medical care. Rather, it is about distribution of the burden of paying for government programs, whether or not they include the provision of free medical care or the reimbursement of medical expenses generally. That is a matter which is intrinsically of more import among the wealthy than among the poor under a graduated tax because they are the ones who bear the heaviest tax burden, however it may be distributed among them.

In short, not only are the dominant considerations affecting identification of the ideal personal income tax base horizontal rather than vertical, they are horizontal among the well-to-do rather than the poor for the simple reason that the graduated rate schedule gives high bracket taxpayers the greatest direct interest in how they are resolved.

Allocation Effects

The argument for the medical expense deduction rests on equity or distributional considerations, but the deduction can be criticized on the ground that it will lead to inefficiency in resource allocation by inducing people to spend more on medical services than they otherwise would. That criticism deserves some answer.

To begin with, it is unlikely that the medical expense deduction will lead people to spend more for medical services than they would have in the absence of an income tax. The effect of the income tax with a deduction for medical services is like that of a price increase for goods and services other than medical care. The substitution effect of the tax will be to favor medical expenses since one can purchase more medical services than before by giving up any particular amount of other nondeductible items. On the other hand, the income effect will be to burden medical expenses since the tax will leave less to spend on everything, deductible or not. There is no a priori way to judge which effect will predominate, but it seems likely that the substitutability of medical services for other goods and services will be too low for the substitution effect to prevail.

The effect on medical services is formally analogous to the effect of the income tax on the pursuit of leisure activities. Since leisure is not reflected in taxable income, the price or substitution effect of the tax is to favor substitution of leisure for purchased goods and services; the tax is a disincentive to remunerative work. But the income effect of the tax will be to make taxpayers work harder in order to maintain their desired level of expenditures. Leisure is one of the things a taxpayer may sacrifice to pay the tax, whether or not it is included in the base on which the tax is computed. In theory there is no a priori way to know which effect of an income tax on the choice between work and leisure will predominate. In practice the tax does not seem to have led people to stop working. Apparently the substitutability of leisure for other goods is too low for people to respond to the tax by a substantial increase in leisure time pursuits.[53]

Without a medical expense deduction the income effect of an income tax would be to lead to a reduction in expenditures for medical care like everything else. The deduction may more or less offset that effect, leaving the level of expenditure for medical expenses about where it would have been without the tax. There is, indeed, some indication in the legislative history that this was part of Congress' purpose in enacting the deduction. With the imposition of wartime tax rates in 1942, it was intended not to have the tax lead people to skimp on medical care.[54]

However that may have been as a wartime policy, in the long run it would arguably be better to make the tax neutral as between medical care and other goods and services to be purchased out of private, after-tax funds. Continuation of the deduction will have a tendency to produce an inefficient overallocation of resources to medical care by leading taxpayers to purchase medical care as if it cost less in relation to other goods and services than it actually does. In theory this point seems generally sound; but again, in practice its importance depends on the degree to which taxpayers in the relevant income range are sensitive to changes in the relative price of medical care.

To the degree that such sensitivity exists, we admittedly are left in a position where distributional considerations seem to justify exclusion of medical services from an ideal income tax base, while allocational considerations provide a reason for avoiding the exclusion. I know no logical way out of this dilemma. In assessing the practical choice to make, however, there are a few more things to say.

First, if it were very important to avoid the allocational effect of the deduction, then theoretically one could leave the (horizontal) distributional problem to be taken care of by insurance. People would pay their insurance premiums out of after-tax income, but would not be taxed on benefits received. Accordingly, the consumption component of their taxable income would reflect whatever level of coverage they chose to pay for without reflecting differences in need and actual utilization of services. But insurance is not equally available to everyone; there are substantial administrative costs associated with insurance; and, in practice, insurance itself seems to lead to some overallocation of resources to medical care because at the point of choice of treatment the patient will benefit from more expensive treatment without bearing the correlative cost. Insurance, therefore, provides no easy, practical way out of the dilemma.

Second, the allocation effects of the medical expense deduction should be compared with those of medicare and medicaid. These programs provide some evidence that government payment of medical expenses can stimulate effective demand and bring about an increase in prices for medical services.[55] But these programs provide for payment of all or most of the cost of medical care for people who otherwise might well have had to do without. The medical expense deduction is unlikely to have so dramatic an effect.

Finally, in assessing the need for price neutrality with respect to medical services, it should be remembered that the tax is manifestly unneutral with respect to earnings decisions and choices between business and personal expenditures. To a limited extent these biases may interact with and even offset those created by the medical expense deduction.[56] More generally, they simply show that total price neutrality is beyond the realm of practical possibility under an income tax and that some conflict between distributional and allocational objectives is rather typical of the whole enterprise.[57]

I would be happy to be instructed further on the allocation effects of the medical expense deduction. In the absence of more information, however, I conclude that any misallocation produced by the medical expense deduction is harmless enough to be clearly outweighed by the distributional considerations that justify the deduction.

III

THE CHARITABLE CONTRIBUTION DEDUCTION

Since 1917 a deduction has been allowed for contributions to religious, educational, and charitable organizations.[58] The deduction is subject to some rather complicated but relatively generous percentage limitations;[59] it also contains some quite complicated provisions and restrictions dealing with contributions of appreciated property and of limited interests in property.[60] Currently, the deduction is claimed on 95% of returns with itemized deductions, or 46% of all returns.[61] The aggregate amount deducted in 1970 was $12.9 billion or about 2% of total adjusted gross income.[62] The revenue cost of the deduction has been estimated at $3.475 billion per year or about 4.0% of total personal income taxes.[63]

The charitable contribution deduction is generally described as a subsidy to charitable giving and thus to the activities of qualified charitable organizations.[64] The effect of the deduction has been likened to a matching gift program under which an employer makes matching gifts to charities supported by its employees. There is something peculiar, of course, about the Government spending funds with so little control over their allocation or use. Furthermore, this is an unusual matching gift program because the rate at which gifts are matched varies directly with the taxpayer's marginal tax rate bracket: wealthy taxpayers find their gifts much more generously matched than do lower bracket taxpayers. A 70% bracket taxpayer can make a $100 contribution at an after-tax cost of only $30; by way of tax reduction, therefore, the Government can be seen as contributing $70 to match the taxpayer's $30, for a matching rate of 233%. By similar computation, a 40% bracket taxpayer will find that the Government provides a matching grant of only $40 for his charitable contributions of $60, or a 66⅔% matching rate; a 20% bracket taxpayer will find the Government's rate for matching his contributions to be only $1 for every $4 he contributes, or 25%; and one too poor to pay any income tax in any event will find the Government unwilling to make any matching grant at all. In the case of a contribution of appreciated property by a 70% bracket taxpayer, the analysis can be extended to indicate that the Government will take over the whole cost of the contribution, and even pay the taxpayer a 5% tax-free bonus to boot.[65]

But I do not believe, nor do I think most serious practical students of the subject believe, that the charitable contribution deduction is as irrational as this explanation makes it sound. To be sure, there are anomalies arising out of the allowance of a deduction for the fair market value of appreciated property without any offsetting recognition of gain.[66] But as to simple cash contributions, the charitable deduction makes more sense than tax expenditure analysis would indicate. If we want our theories to express our judgments, therefore, we should seek to give the deduction a better explanation.

As in the case of the medical expense deduction, there are substantial grounds for excluding from our definition of taxable personal consumption whatever satisfactions a taxpayer may get from making a charitable contribution. The charitable contribution deduction is quite different from the medical expense deduction since there is no reason to view the charitable contribution as offsetting some particular personal hardship like disease or injury. But there are other good reasons why a charitable contribution may rationally be excluded from the concept of taxable personal consumption. In the case of alms for the poor, for instance, the charitable contribution results in the distribution of real goods and services to persons presumably poorer and in lower marginal tax brackets than the donor. These goods and services, therefore, should not be taxed at the higher rates intended to apply to personal consumption by the donor. In the case of philanthropy more broadly defined—the support of religion, education, and the arts—benefits often do not flow exclusively or even principally to very low bracket taxpayers. But the goods and services produced do have something of the character of common goods whose enjoyment is not confined to contributors nor apportioned among contributors according to the amounts of their contributions. There are a number of reasons for defining taxable personal consumption not to include the benefit of such common goods and services. The personal consumption at which progressive personal taxation with high graduated rates should aim may well be thought to encompass only the private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others.

Various objections can be made to this analysis. It can be argued that the exercise of power over the distribution of goods and services is what constitutes taxable personal consumption even if that power is exercised in favor of somebody else. Or it can be argued that the pleasure or satisfaction one presumably gets from supporting philanthropic enterprises is a component of consumption. But at least this analysis and the objections to it focus on the problem of how to treat philanthropy as an intrinsic issue of personal tax policy, instead of just assuming that the purpose underlying the deduction must be something outside the realm of tax policy.

It is convenient to take up first the case of alms for the poor, then philanthropy more broadly defined, and finally the special problems that arise when charitable contributions are made out of accumulated wealth rather than current earnings.

Alms for the Poor

Consider a taxpayer who simply contributes some of his earnings to an organization which redistributes them to or for the needy. In such a case the consumption or accumulation of real goods and services represented by the funds in question has been shifted to the recipients rather than the donor and should not be subjected to taxation at rates designed to apply to the donor's standard of living and saving. If the redistributed funds are used for ordinary consumption by the recipients, then in principle the funds should be taxed to the recipients at their rates—although in practice the recipients' total income may often fall below a taxable level. The matter is essentially one of rates. Under a graduated rate schedule the personal consumption and accumulation of well-to-do taxpayers is intended to be curtailed much more than that of the poor. Yet if a wealthy taxpayer were to be taxed at his high rate even on the income that he donated to the poor, the probable effect would be a reduction in the amount received by the donees. For all practical purposes, such a scheme would tax the consumption of the poor at the rate intended for the wealthy taxpayer. The effect of the charitable contribution is to avoid this result.

Moreover, the charitable contribution deduction operates to treat a taxpayer who redistributes his income by giving alms like other taxpayers who effect a redistribution of income directly. A businessman, for example, may pay generous wages, higher than he would have to pay in order to secure the services he needs. If he does so, within reason, we would not tax him on the additional income he could have earned by paying less. He has arranged his business in a way that diverts more income to employees and less to himself; the tax law generally will deal with the income as so redistributed.

More to the point, perhaps, a doctor might choose to spend one day a week in a clinic without charging for his services. More generally he might simply treat impecunious patients for less than the going rate. In either case he has foregone in favor of the patients whom he treats some of the personal consumption and accumulation he could have had. We do not tax the doctor on the value of his services or the excess of the value of his services over the fee he charges. We tax the doctor only on the personal consumption and accumulation he achieves by the exercise of his profession, not on what he could have achieved if he chose to maximize his personal financial gain.

Another professional man, a tax lawyer for example, may have skills that are not so directly useful to the poor as those of the doctor. If he wishes to devote part of his professional energies to the welfare of the poor, the efficient way to do it may well be to continue practicing his profession for paying clients but to turn over part of his fees for distribution among the poor or for the purchase of other services to meet their needs. The charitable contribution deduction operates to treat the tax lawyer like the doctor, by taxing him only on the amount of personal consumption and accumulation he realizes from the practice of his profession, not on what he could have realized if he had not given part of his fees away.

But this analogy between the tax lawyer who makes charitable contributions and the doctor who performs services directly for the poor suggests another that will serve to raise a number of difficulties with this analysis. If the doctor provides services free for some of his friends and relations, remote or immediate, in practice, at least, we would not seek to tax him on the value of such services. But if the tax lawyer turns over part of his fees to his friends and relations we would not allow him a deduction. Why is there any more reason to be persuaded by the analogy in the case of poor recipients than related recipients?

1. *The Problem of Ordinary Gifts.*—In the case of an ordinary gift between friends or relations, the donor is allowed no deduction even though he has in one sense given up the personal consumption or accumulation that the donated funds might have purchased. On the other hand, we do not tax the recipient of the gift, even though clearly his personal consumption or accumulation will be enhanced. The result is that income earned by one taxpayer and then given to another who devotes it to personal consumption or accumulation is taxed once and only once, albeit to the donor rather than the donee whose consumption and accumulation it ultimately supports. Ideally, perhaps, the tax should be on the donee rather than the donor. But it is much simpler for everyone concerned to leave ordinary interpersonal gifts out of the computation of income on both sides. And if the income tax rates of the donor are appropriate for consumption or accumulation by the donee, the result is perfectly acceptable.

What warrant is there, however, for thinking that the donor's rates are fit for the donee's consumption or accumulation? Perhaps it is assumed that interpersonal gifts occur mostly between members of the same family or between people of similar social and economic status whose income tax rates are likely to be similar. But that is not a very realistic assumption, particulary in the case of intrafamily gifts which often go from a high bracket adult to a child in a lower bracket.

A sounder explanation for our treatment of at least intrafamily gifts may rest upon the fact that consumption is largely a household rather than an individual function. In the most usual case one member of a household earns the income which supports the whole household, and the convenient way to collect a tax is to impose it on the earner individually. But the rate and exemption schedules[67] applicable to the breadwinner are designed to cover consumption and accumulation by the whole household without regard to the precise way in which consumption is distributed among household or family members and without distinctions between intrafamily transfers by way of support and transfers by way of gift. In other words, income is ultimately to be taxed at rates appropriate to the household whose consumption it supports although those rates are expressed in terms of an individual rate schedule applied to the breadwinner.

I do not suppose the tax has been consciously designed on this premise. The more common view is that income is to be taxed to him who earns it, regardless of whose consumption it goes to support. But, again, much of what we do with the income tax can be better understood if we reinterpret it as an indirectly measured tax on personal consumption and accumulation.[68] And while people participate in the production sector on an individual basis, consumption and accumulation are largely household functions. Therefore, it is sensible to view the individual income tax on the breadwinner as an indirectly measured tax on the consumption and accumulation of the household.

On the face of it the taxation of spouses' incomes on a joint return would seem to be consistent with this interpretation, while the failure to include children's income on their parents' return would not. In fact, the case may be viewed the other way around. To be sure, if the tax is on household consumption plus accumulation, then it should be measured by total household income. But differences in sources of income may indirectly reflect differences in consumption and accumulation that should be taken into account. In particular, when a spouse or a child has his or her own earnings, there has been a sacrifice of leisure time (which in the case of a child may involve substantial educational opportunities) or services performed in kind within the household, as compared with a household in which only one person has any earnings. Reporting children's earnings on separate returns may serve to reduce aggregate tax liability in a way that takes rough indirect account of this sacrifice,[69] while the joint return and split income provisions applicable to a working spouse operate inappropriately to obliterate any difference in rates between households where both husband and wife work and households where one spouse remains at home.[70]

This is not the place even to begin to explore all the implications or problems of viewing the individual income tax as an indirectly measured tax on household consumption and accumulation. The purpose of sketching that view here is only to suggest a pattern that would make it rational to treat ordinary gifts differently from charitable contributions, letting the recipient's consumption of the gift be reflected in the donor's return and taxed at his rates in the former case but not in the latter. If we interpret the difference in treatment this way, it implies that the household whose consumption is indirectly reflected on an individual's income tax return is not defined rigidly in terms of prescribed relationships. Instead, it is more flexibly conceived as embracing all his friends and relations to whatever extent he may in fact choose to support or entertain them at his expense.[71] Within the extended household, so conceived, it is likely that tax rates may be more or less comparable, except as lower marginal rate brackets reflect leisure time that justifies at least a somewhat higher aggregate rate. In any event, the complexity and variety of the transfers of consumption benefits among persons so related is such that any attempt to get all benefits on the individual returns of those who enjoy them would be hopeless. Consumption is in large part a shared activity among friends and relations.

Against this background the charitable contribution deduction may be seen as eliminating from a taxpayer's return only that consumption which he shifts beyond the confines of his own household, even as rather broadly and flexibly conceived. It thus provides an escape from the convenient rule, which taxes the donor on the consumption represented by his gifts, in those cases where the rate differential, and consequently the relative hardship arising from application of the convenient rule, is likely to be most significant and where an organization exists for the collection and disbursement of funds which makes it practical to establish and audit the amount of redistribution from donor to recipients. This interpretation not only suggests what some of the definitional problems surrounding charitable contributions may be,[72] but also suggests, perhaps serendipitously, why the deduction is defined in terms of identity of a qualified donee organization, instead of directly in terms of the use to which funds are put.[73]

2. The Problem of Imputed Income.—Comparing the doctor with the tax lawyer, however, raises another set of objections. We do not tax the doctor on services performed free, it may be said, because no income is considered to be realized unless something is received in exchange for the performance of services. That reason has no application to the tax lawyer who is paid for his services, whatever he may subsequently do with the fees. It can be argued, accordingly, that our failure to tax the doctor on the performance of uncompensated services, whether for the poor or for his friends and relations, is only an example of favored treatment which we extend to imputed income generally.

But that line of argument admits the criterion of realization into our concept of an ideal personal tax where it does not belong. It is true that we do not generally tax imputed income from services performed within the household, but that fact represents a concession to practical considerations rather than any underlying principle of fair distribution of tax burdens. There is no way to prove it logically, but I think the exemption of imputed income from services performed outside the home in a charitable enterprise is something we feel to be right in principle, not merely for reasons of convenience. If that judgment is correct, then there is a policy basis for extending the same treatment to the tax lawyer who contributes a portion of his income to the poor.

There frequently are limitations that make the nontaxation of imputed income from services performed within the household acceptable in practice even if wrong in principle, but which do not apply to the performance of services outside the household. The goods or services one can produce for use within his own household are limited in value because the processes employed cannot be brought to bear upon a large enough volume of production to generate the kind of high pay that the performance of specialized services will command in an exchange economy. A doctor performing services within his own household, for example, will not usually find enough sickness to be able to produce a large volume of medical services, relatively speaking, beyond the reach of the tax law.[74] Similarly, while an entertainer may earn large fees for performing before large audiences, the imputed income that escapes tax when he performs at home for his family is very limited if measured by the relative size of his audience. There is thus imposed on the enjoyment of imputed income from services within the home a kind of built-in limit that makes it practically acceptable to omit such services from the computation of taxable income, even if in principle they should be included.

But there is no such built-in limitation with respect to the performance of services in kind for a charity. A doctor may indeed perform a significant percentage of his professional services for less than a full fee on a charitable basis. Or an entertainer may perform for charity before a large audience. If we think it is right not to tax the doctor or entertainer on these services,[75] which do not have the built-in value limitation, a more basic principle must underlie the exemption than the concession to practicality which operates in the case of imputed income from the performance of services within the household. And in that event the principle should be extended to the tax lawyer as well.

In effect, with respect to the performance of services for the ultimate objective of enhancing one's private standard of living, the test of taxability is participation in the exchange economy. The doctor or the tax lawyer can perform services within the household free of tax; but as soon as either performs services outside the household in exchange for something to be consumed within the household, he will be taxed. However, when the ultimate objective is not to support consumption within the household, either directly or through exchange, then the rationale for limiting the performance of taxfree services to those occurring within the household disappears. The amount of medical services the doctor can perform on a charitable basis will not be practically limited by the amount of sickness within his own household, but the exclusion of the value of these services from taxable income can be justified since they do not support the doctor's aggregate personal consumption or accumulation. There is no reason why the tax lawyer should not be equally free to bestow the benefit of his professional skills upon the poor, free of income tax at his rates, by selling his services and turning over the proceeds.

3. *Consumption as Power.*—A more general argument against a deduction for almsgiving is that the tax should be apportioned on taxpayers' power to consume, however that power may be exercised. The income tax is supposed to be a tax based on ability to pay, not on what one does with that ability. To say that the ultimate object of the tax is consumption plus accumulation does not foreclose that argument, because consumption can be construed to embrace any exercise of power over the disposition of consumer goods and services even if that exercise does operate to benefit others.[76]

The difficulty with defining taxable consumption as the exercise of power over the disposition of goods and services is that we cannot, and probably would not want to, carry such an approach very far. Only a part of the power that people exercise over the allocation and distribution of economic resources is represented by the expenditure of money. The direct influence of people participating in political and economic affairs cannot practically be subjected to income taxation.[77] Moreover, we probably would not want to tax the exercise of power as such because the effect would be to channel some of the energies of the people involved away from these activities toward earning the funds with which to pay the taxes.

We do not tax people who exercise power through direct participation on what they could have earned if they had devoted their full energies to earning money. By analogy, it is reasonable not to tax others on what they have earned and could have kept for their own use if they choose not to keep it. If we take a broad view of how the tax falls on people who lead different kinds of lives, of how we intend it to fall, and of how it is practical to make it fall, it is not according to their powers that we should tax people but according to their standards of living and personal saving. And that is very much a matter of what they have chosen to do with their powers.

It will be answered that the tax is not on power generally, but on a power that could have been exercised for the taxpayer's private benefit, whether it was so exercised or not. But even that power cannot be measured with any accuracy by realized income. The doctor who works for a clinic is similarly exercising a power which he could have used to secure a higher level of personal consumption and accumulation for himself. So too is the businessman who pays generous wages, or the clergyman or teacher who could have earned more money at another calling. It would be impractical and undesirable to try to tax all such people on what they might have earned if they had set their minds to the business of earning money.

4. *The Pleasure of Giving.*—Finally, there is a kind of argument against the allowance of a deduction for alms to the poor which is based not on power but on pleasure. The argument is that one who makes a charitable contribution must get some pleasure or satisfaction from his act which he considers equal to what he could have gotten from some other use of his funds.[78] Some wealthy people dress for dinner; some ride to hounds; others make substantial charitable contributions. *Chacun a son gout.* Whatever a man chooses to do with his money should be classed as personal consumption for him.

But there is a difference between dinner clothes and charitable contributions. Wearing dinner dress represents some diversion of economic resources, real goods and services, *away from* the satisfaction of other people's needs. The effect of almsgiving, on the other hand, is to cause real economic resources to be directed *toward* the satisfaction of the needs of the poor. Thus, the imposition of a tax on this latter kind of expenditure will ultimately fall on the poor in a sense that it will not in the case of dinner dress. The satisfaction one gets from making a charitable contribution is in this respect like a great many of the rest of life's best satisfactions which people can enjoy without diverting economic resources away from other people and which we do not try to take into account in assessing income taxes.

Taxable consumption in the end does not and cannot provide an accurate relfection of either power or pleasure. It is, rather, simply the accumulation of utilization of economic resources, measured at market value, for private consumption within the taxpayer's household. That definition is consistent with the practical purpose of the tax—to divert some economic resources to public uses in a manner that will reduce disparities in standards of living and saving. One might wish also to reduce inequalities in power or pleasure more generally, but those wishes are beyond what it is practical to expect an income tax to accomplish.

Philanthropy More Broadly Defined

For many kinds of charitable contributions the foregoing analysis will not quite do because the benefits of the contributions do not go entirely to the poor. More than half of all charitable deductions are for contributions to churches,[79] whose activities are conducted for rich and poor alike and often on a more comfortable and expensive scale in wealthy neighborhoods than in poor ones. Many contributions are to private schools,[80] whose student bodies are probably still disporportionately representative of the affluent part of the population. Some contributions go to support artistic enterprises, ordinary and esoteric, in which most of the poor are likely to have little interest. Moreover, the activities of such organizations are frequently ones in which contributors participate more or less directly for their own edification or pleasure.

Such contributions also differ from alms for the poor because they represent an affirmative allocation of resources by the contributor to a particular activity whose benefits are not taxed to the recipients. In theory, though not in practice (and it is typically not important in practice), alms should be counted as income to the recipient, so that deduction by the donor is only a matter of reassigning taxability to the person whose consumption is supported, as in the case of alimony.[81] But when a group of wealthy people support a church, a school, a research institute, or a symphony orchestra, the effect of the charitable contribution deduction is to eliminate the enjoyment of the output of that activity from the tax base altogether. A community of people that supports a church will pay less in taxes than a community of people with the same total income, similarly distributed, that spends less on its church and more on its private homes.

Nevertheless, the benefits produced by charitable contributions have certain shared characteristics which provide the basis for principled arguments in favor of deduction. Almost all charitable organizations other than those that distribute alms to the poor produce something in the nature of common or social goods or services. The benefit produced by a contribution to a private school, for example, may not inure primarily to the poor, but neither does it inure solely to the contributor. Even when contributors are almost all members who share in the product of the organization, as in the case of a church, the product is essentially a common good to be enjoyed by the members without regard to relative contributions and usually is at least open to enjoyment by others.

Common goods have several characteristics relevant for our purposes. Principally, their enjoyment is not limited exclusively or even primarily to those who pay for them. That might be stated merely as a matter of external benefits: a wealthy man cannot purchase and enjoy the sound of a new church organ without conferring a benefit on his fellow parishioners. Unlike the typical external effect of private consumption, however, the benefit conferred on others is of the same kind as that enjoyed by the contributor himself.

Moreover, it is typically the case that the benefits produced by a charitable organization are free goods in the sense that one person's enjoyment of them will not directly impair another's enjoyment. Attendance at church on a particular Sunday, use of the town library, or listening to a symphony orchestra broadcast will not immediately prevent someone else from doing the same thing. Of course, pure public goods are relatively rare. Use of the library does not immediately prevent others from using it; but if too many use it too much, then its utility will be impaired. The conditions under which a town common can serve effectively for common use are very limited.[82] And students' places in schools are sometimes quite scarce. But as among the students, once admitted to a school or to a particular class, many of the educational opportunities offered have this quality of common goods.

The underlying problem with respect to contributions to churches, schools, museums, and similar charities is whether the common goods they produce should be reflected in the consumption component of personal income of any of the individuals associated with them.

1. *Taxing the Recipient on the Value of Services Provided by Charities.*—If the personal income tax is ultimately to be seen as a tax on total personal consumption and accumulation, then on the face of it the value of services provided by philanthropic institutions ought to be included in the taxable

income of the recipients who benefit from those services.[83] To the extent a taxpayer pays for such services received—by paying tuition or purchasing tickets, for instance—his taxable income will reflect the services so purchased. But in practice we make no attempt to tax recipients on the value of services financed through voluntary contributions or tax-exempt endowment income. Why not?

Partly, of course, the answer is practical: there is often no satisfactory way to put a value on the benefits provided by a charitable organization to a particular recipient beyond the price he has had to pay to receive those benefits. But I think the matter runs deeper, and we would not want to tax the receipt of such benefits even if we could.

Consider, for example, the benefits conferred by a church upon its members. There is no satisfactory way of measuring the benefit conferred on any particular member. Even if we took the church budget as setting a prima facie value or price on the total of benefits produced for its members, there is no adequate method of determining distribution of those benefits among church members for individual income tax purposes. And even if we could put values on such things, I doubt if we would want to include them in taxable income. Whatever considerations lead most churches not to charge admission may make it undesirable, as well as impractical, for the state to define taxable consumption, in such a way as to impose a secondary admission charge in the form of a tax burden.

Or consider educational institutions. Tradition provides a way of pricing individual benefits from school attendance through uniform tuition charges, and in fact we generally tax students' families on that part of the value of their education by denying any deduction for tuition payments.[84] Insofar as either the cost or value of educational services exceeds tuition, however, it would be difficult to measure that excess for any particular student. And again, even if we could measure the excess, I do not think we would want to tax the recipient on it. Indeed, even when there is an established tuition charge but some students have the charge defrayed by scholarship aid, no tax is imposed.[85]

The reasons for not defining taxable personal consumption to include the value of educational services in excess of the price paid are akin to those for maintaining free public schools. In part, we make education free in order to try to equalize educational opportunity among different income groups. But that consideration alone would support only a policy of graduated charges or free schooling for the poor. Moreover, when we provide quality higher education, we go far beyond equality. Not everyone will have the taste or capacity for that particular commodity; those who do are apt to be disproportionately from relatively well-to-do homes.

A more general reason for free schooling is the conviction that the ultimate benefits from schooling flow beyond the immediate recipients. General education makes better citizens. Higher education prepares people for roles of leadership of one kind or another. Moreover, there are diseases to be cured, legal disputes to be resolved, technologies to be invented, and scientific principles to be discovered, all of which will not be done if society fails to concentrate the necessary educational resources on those who can do the work. In our society, of course, a higher education may lead to higher earnings; but then we will tax those.[86] Any other individual benefit to the student from a higher education is like the benefit that flows to anyone from having an interesting and self-fulfilling role to play. Insofar as the satisfactions from an education are not reflected in earnings, they are like job satisfaction which we are perfectly content neither to charge for nor to tax.[87]

The exact reasons for not taxing the recipients of other charitable services may vary from case to case, but in general they will arise from both the impracticability of measuring individual benefits and the undesirability of thwarting whatever purposes led the charity to make the provision of the services wholly or partly free.

2. *Taxation of Charitable Contributions as a Proxy for Taxing Benefits.*— The denial of a charitable deduction, however, would not involve the impracticability of measuring individual benefits and would avoid some of the undesirability of imposing a direct tax cost on the recipient for a service the charity meant to provide free. Denial of a deduction would operate just as with any other personal expenditure to impose a tax on people according to what they do pay for charitable services, by way of contributions as well as direct charges. And while theoretically the contributor may be the wrong person to tax, he is free to respond to the tax by reducing his contribution so that the burden would be shifted indirectly to those who enjoy the benefits of the charitable activity. In the case of ordinary household consumption, a tax collected from those with the income casts its burden automatically on all those whose consumption the income goes to support. It thus serves as a proxy for a tax on all of them. If a tax on income contributed to a charitable enterprise would similarly serve as a proxy for a tax on benefits, then at least the activity would bear a tax burden comparable to that borne by other consumer activities.

There are several difficulties, however, with taxing contributions as a proxy for benefits. First, the rate of tax that would result from denying a deduction for contributions would often be too high for the people who enjoy the benefits. Individual income tax rates are designed to apply to the private household consumption which any particular level of income is likely to support. Indeed, major differences in household responsibilities are reflected in different rate schedules and exemptions.[88] Individual rate schedules are not similarly adapted to apply to consumption by the wider community typically served by a philanthropic enterprise.

The contributions that support any particular charitable enterprise are likely to come disproportionately from a relatively few contributors who have higher incomes and are in higher tax brackets than the average for those interested in the enterprise. Benefits are not similarly concentrated on the wealthiest. Thus, even though a suburban church may fail to provide much in the way of services to the very poor, its mode of financing does bring about some internal redistribution, which would tend to make a personal tax at contributors' rates cast an excessive burden on the community as a whole. Insofar as the quality of common goods available to the affluent is generally better than that available to the poor, a better way of reflecting the difference may be just to impose a higher or more steeply graduated rate of tax on private consumption.[89]

Second, the impact of taxing contributions as a proxy for benefits might well be excessive even apart from the matter of rates because of the dissociation that exists between payment of contributions and enjoyment of benefits from charitable organizations. An income tax ordinarily operates to make a person reduce his expenditures but leaves him free to decide for himself which expenditures to reduce by how much. Taxable consumption includes both food and clothing; a taxpayer may choose, however, to cast the burden of the tax wholly on one category in order to avoid any reduction in the other. As among private, preclusive consumption expenditures the reduction will be distributed among items under the constraint that any particular expenditure reduction will immediately produce a corresponding reduction in consumption benefits. In the case of contributions there is no such immediate connection. Whether the services produced by a charitable organization and enjoyed by a contributor will be reduced does not depend immediately and solely on his contributions but on the sum of all contributions by all contributors; thus a rationally self-interested taxpayer might be tempted to let his contributions bear more of the burden of a tax than do his private consumption expenditures.[90]

For these reasons the effect of taxing contributions as a proxy for benefits might be to cast an excessive burden on charitable services. Indeed, philanthropic activities may well bear part of the burden of the personal income tax even if they are deductible, since there is nothing to prevent contributors from responding to the tax by cutting contributions. At least a deduction for contributions may help, however, to avert or mitigate excessive movement in that direction. Legislative history tends to indicate that this was the congressional view that led to enactment of the deduction. It was feared that high rates of tax in 1917 might cut off the flow of funds to philanthropic uses, and the deduction was to prevent that effect.[91]

There is some analogy in these respects between the support of philanthropy and the cultivation of leisure. Part of the reason an income tax does not in fact seem to make people quit work is that if they want to maintain their old standard of living they have to work harder for it. Although leisure is not directly included in the tax base, one way to bear the tax is through a sacrifice of leisure. The price effect of the tax favors leisure, but the income effect may be a burden on it.

Similarly, one can maintain his standard of living in the face of an income tax by cutting charitable contributions even if they are made deductible. With a deduction there is a price effect in favor of giving as compared with nondeductible expenditures, but with or without the deduction the tax has an unfavorable income effect on contributions. There is no sure way to know with respect to either leisure or charity whether the income effect or the substitution effect will prevail. There may be some reason to think, however, that both philanthropy and unexercised earning power[92] are among the things a person might give up first in response to a reduction in income. Philanthropy in its broader senses may be, like the cultivation of leisure, a kind of delicate flower of human activity best removed from the direct burden of the income tax which can better be borne by those hardier, self-preservative and self-centered instincts that underlie preclusive private consumption of divisible goods and services.

3. *Taxing the Contributor in his Own Right.*—Most critics of the charitable contribution deduction would probably argue that contributors should be taxed in their own right on income donated to charity, not as proxies for the recipients of services. Charitable contributions are a use of income by the contributor that should not be treated differently from any other personal, nonbusiness expenditure. The benefit to be reflected in taxable income is the benefit to the contributor that motivates him to make the contribution, not the effect on someone else.

Insofar as the benefit to the contributor is the pleasure of giving, the argument runs into the same difficulties as in the case of alms for the poor.[93] The arguments are also essentially similar insofar as the benefit is conceived simply as an exercise of power not to devote resources to one's own private, preclusive, household consumption.[94] But one who contributes to a symphony orchestra instead of a rock group, to the construction of an opera house instead of a soccer stadium, or to the support of a liberal arts college instead of a vocational training school is exercising an affirmative influence over the allocation of resources to one activity rather than another, and it may be urged that this exercise of power ought itself to be subject to tax.

One view would be that income represents power over resources and that an income tax should be designed to curtail affirmative exercises of that power, in whatever sphere, on a horizontally equitable basis. But an income tax cannot be made to bear very equitably on exercises of power or influence as such in any event. Again, people wield power over the allocation of resources in all sorts of ways that do not involve the expenditure of after-tax funds. In the case of churches, schools, and other operating philanthropic institutions, many people make direct contributions of time, energy, and talent, and there is no reason to think they do not have a very substantial influence over their institutions. Yet we do not try to tax them on that. In the world beyond particular philanthropic institutions, people wield influence or power by how they perform their jobs; by the jobs they take; by devoting time and effort to the cultivation of political influence, through seeking public office or otherwise; by writing influential books or speaking effectively in public; and in any number of other ways. The income tax cannot reach these acts. Even if we confine attention to money expenditures, people exercise power over the allocation of resources by making or controlling the making of deductible business expenditures, and the income tax does not reach these acts.[95] In a world in which power is exercised in so many ways, it might be a step very much in the wrong direction to make the tax bear upon the exercise of power through charitable donations while leaving all these other things free of tax. The effect of the deduction is to make the impact of the tax more consistent by drawing a line in effect between private, preclusive, household consumption on the one hand, and the exercise of power or influence outside the household on the other, and then confining the burden of the personal income tax principally to the former.

The exception that proves the rule may be the matter of political contributions. Traditionally, we have not allowed any deduction for political contributions, and even now there is little disposition to allow an unlimited deduction for political contributions because this would enhance the influence of the wealthy.[96] We do allow a citizen to participate in politics without imposing any tax on the value of his participation; but we do not grant him a deduction for large contributions. Similarly, we might permit a person to devote his energy directly to the promotion of philanthropic pursuits without allowing a deduction to those who provide their support through monetary contributions.

But there are very particular reasons for limiting the deductibility of political contributions that do not apply equally to charitable contributions. We fear oppression if wealthy people are able to dominate the political process. Nondeductibility of political contributions is a small, ad hoc way of lessening the threat of such dominance. Indeed, it is widely felt that we need to do more to limit the influence of money in politics. Political power is monolithic in the sense that it is all to be exercised through one set of closely interrelated institutions over which we do not want the rich to capture too nearly complete a control.

Charitable organizations, on the other hand, are numerous enough, and sufficiently voluntary in their membership relations, so that we need not have the same fear of oppressive domination by wealthy contributors. Some organizations may devote resources to subjects of limited public interest, but others pursue subjects of quite general concern. The variety of common cultural goods that voluntarily supported charities will produce or pursue is itself a value worth preserving, even at the cost of supporting some enterprises our platonic guardians might find individually unworthy.[97]

Following the tax expenditure analysis, it has been asserted that the charitable contribution deduction enhances a wealthy contributor's influence by causing the Government to make matching grants at a rate determined by reference to his marginal tax bracket. To avoid this effect it has been suggested that the deduction be replaced with a credit against tax[98] or even with a system of direct matching gifts to qualified charities,[99] either at a single flat rate or at rates graduated according to the percentage of income a particular donor contributes. If a taxpayer makes total contributions of $1000 in a given year, then instead of deducting $1000 from taxable income, he might subtract some percentage of $1000 from his tax; the percentage might be higher for a lower income taxpayer because to make that size donation the lower bracket taxpayer is presumably making a greater sacrifice. The rates of credit or matching grant would be set to try to approximate the overall effect of the present deduction by keeping the total flow of contributions constant. Private philanthropy would thus be preserved, but the power and influence that go with making contributions would be spread more evenly among the people.

Under a tax credit generous low bracket taxpayers would get more than a forgiveness of income tax on funds donated to charity: because of their donations they would get a forgiveness of tax on some funds devoted to private consumption as well.[100] On the other hand, a high bracket taxpayer of only moderate generosity would find he still had a net tax to pay on income devoted to charity. For him the tax law would offer an inducement to quit work and make music himself, or play golf, instead of contributing to the symphony. In theory, at least, high bracket taxpayers might respond to the shift from deduction to credit or matching grant by reducing both their donations and their earnings, and then both charitable contributions and public revenues would suffer.

The credit or matching grant suggestion derives, of course, from the tax expenditure analysis, which already regards the tax law as subsidizing charitable contributions in an amount equal to the additional tax that would have been collected if the donated funds had been devoted to private consumption or accumulation. But, again, to assert that the deduction represents a subsidy is just to assume the result—that the contributor should be able to contribute only from after-tax funds. The deduction can be described alternatively as a mere exemption of all charitable contributions from the category of private consumption subject to tax. Such a provision may or may not be a good idea. But the net effect of substituting a credit for the deduction would be to tax some contributors on their contributions while subsidizing others, and so viewed the suggestion seems to be a very doubtful one. That is, it is understandable to say to a high bracket taxpayer that he will not be taxed on funds devoted to philanthropic uses of his own choosing. And it is understandable to say, if necessary, that a high bracket taxpayer will be taxed even on such funds because there are other more pressing needs as determined and identified by government action. But it is much less understandable to tell a high bracket taxpayer that he will be taxed on funds devoted to his favorite philanthropies in order to provide funds for the support of other people's philanthropies beyond what they would have been able to provide if no tax had been imposed at all.

Again our treatment of political contributions is instructive. We need an injection of public funds to pay for political campaigns in order to reduce the excessive dependence of elected public officials on their wealthy benefactors. But there is a difficult problem of how to distribute such public funds among all the multitude of candidates running for different offices in different kinds of elections. A matching grant system, through a tax credit with a fairly low ceiling, is one good, practical way of effecting just such a distribution.[101] There is no similar need to utilize the income tax to effect a redistribution of influence over allocation of funds among philanthropic uses.

4. *Neutrality with Respect to Expenditure Choices.*—From a slightly different standpoint it may be argued that the charitable contribution deduction is undesirable—or at least that its justification has to be found outside the realm of purposes intrinsic to the income tax—because it introduces an artificial distortion into the contributor's choice of how to spend his money. A personal income tax is supposed to be neutral with respect to expenditure choices in the sense that while it leaves a taxpayer with less to spend, it leaves him free to decide for himself how to spend what is left. The charitable contribution deduction interferes with his choice by giving him more to spend if he makes charitable donations, and less if he does not.

But once again the personal income tax can be described as neutral only by confining consideration to after-tax expenditures; the tax is manifestly not neutral with respect to any wider realm of choice that includes questions about working hours, early retirement, job satisfaction, and the like, which have an impact on earnings and are therefore affected by tax rates. There is no warrant for confining attention to expenditures or for assuming that neutrality among expenditures will produce the greatest possible neutrality in the wider realm of consumer choice that embraces earnings decisions, or even for assuming that expenditure decisions can be separated in the long run from earnings decisions.

Indeed, it is probably better to describe the personal income tax by starting with the proposition that it is not neutral and cannot be made neutral in any comprehensive sense. The question is not how to eliminate disneutrality or bias but how to arrange it along the most tolerable lines. The tax almost by definition lays a burden on the cycle of activity by which a person earns income and spends it for private, household consumption, while the direct performance of charitable services and the pursuit of leisure activities are left free of that burden. The effect of the charitable contribution deduction is only to put the earning of income and its devotion to charitable uses on the tax-free side of the line.

In considering whether it is wise to put charitable contributions on the tax-free side of the line, income effects of the tax should be kept in mind.[102] Just as the burden of the tax may be borne by working harder, even if the enjoyment of leisure is tax-free, so it may be met by reducing charitable contributions, even if they are deductible. And if support of philanthropy like cultivation of leisure is something one tends to effect only with his surplus funds or time, then it will tend to bear a significant portion of the burden in any event. Again we may come to the conclusion that the pursuits of religion, education, culture, and philanthropy are things best exempted from the burden of a tax designed to rest upon activities with a hardier motivation.

5. *Philanthropy from a Community Perspective.*—It is possible to look at religion, learning, and the arts from a community perspective rather than that of either the recipient of services or the contributor of funds as such. From this standpoint there is a considerable resemblance to the cultivation of leisure within a private household. In the aggregate the effect of allowing a community to support a church, a symphony orchestra, or a university on a tax deductible basis is to allow it to allocate part of its people's time and energy to those activities without having the product taxed. If everyone in the community made his own prayers and music and literary criticism, that would all go untaxed as leisure-time activity. But it may be more efficient for the community to delegate at least part of those functions to specialists who can spend their whole time at them. Insofar as specialization leads one person to produce something that others seek to consume on an individual basis, it leads to an increase in taxable income. But to the extent that specialization produces something shared throughout the community, it may be reasonable

to let it go tax free on grounds similar to those that make it acceptable to exempt the product of individual leisure activities.[103]

Thinking in terms of some community that produces and enjoys the product of a religious or educational or cultural enterprise serves to identify two separable issues with which we must deal. First, how should the distribution of tax burdens among members of that community be affected by their participation in that enterprise; and second, how should the aggregate tax burden of the community be affected as compared with other communities or groups of people who do not maintain such an enterprise?

In answer to the first question we have already seen that it would be impractical, and probably undesirable in any event, to try to take direct account of relative benefits from free services provided by the enterprise.[104] On the other hand, it does not make much sense to tax people according to their contributions to the enterprise. If we assume equal opportunity to utilize the benefits of the enterprise, then one who contributes less than another is better off in that he has the common good and more left for other things. For purposes of apportioning taxes within the community, therefore, it makes sense to look only at private, not communal, consumption. To arrive at that amount it is necessary to deduct charitable contributions from income.

The second question is harder. Is a community that produces and consumes a given quantity of food, wine, clothing, housing, private entertainment, and other private goods and services, and also maintains a church requiring the full-time paid services of some of its people, to be taxed like an irreligious community that produces and consumes somewhat more food, wine, and so forth or like one that produces and consumes the same amount of private goods but in which everyone works a little less and devotes more time and energy to love and song or private prayer? I suppose the matter cannot be resolved by logic, but it seems to me consistent with the general purpose and effect of our tax to adopt the latter as the more persuasive analogy.

The concept of community in this discussion is an amorphous one: it means any group that shares some religious, educational, or charitable common good, whose production is financed by voluntary contributions. A particular individual may be a member of several such groups. In any event, it is not important for operation of the tax that membership in the community be accurately identified because the desired result is achieved by allowing a deduction for contributions, whoever the members of the community may be.

Community in this sense is something of an extension, with respect to certain categories of goods, of the concept of household implicit in our treatment of imputed income.[105] In general, as between members of different households, the price of specialization is subjection to the income tax, since what a taxpayer earns by selling his own specialized product in order to buy other products will be included in taxable income. But goods produced and consumed within the household are typically left out of account in computing income, even when a considerable degree of individual specialization exists within the household.

The charitable contribution deduction can be said to rest upon a judgment that certain common goods financed on a voluntary contributory basis for shared use in a community wider than an individual household should be similarly exempted. Specialization within that wider community will require that the clerics and teachers and musicians be paid so they can eat. Because the taxation of private consumption is to be on a household basis, the clerics and teachers and musicians will be taxed on their salaries. But the contributor households' private consumption or accumulation has been reduced by their contributions. Consequently, a deduction is appropriate unless they are to be taxed on what they have paid the clerics, teachers, and musicians to produce.

The charitable contribution deduction represents a judgment that no tax need be collected on what the clerics, teachers, and musicians have produced insofar as it is distributed or made available as a free good for shared use within a reasonably wide community of persons.[106]

It is sometimes said that the charitable contribution deduction is justified because charitable organizations provide services that otherwise the Government might have to provide directly. One abstract sense in which that statement seems true is that charitable organizations produce common goods. To some extent the basic reason underlying taxation and governmental provision of common or public goods is that people acting individually will not tend to pay voluntarily for the provision of public goods or services up to an optimum level.[107] Insofar as that is the reason for taxation, it may well seem counterproductive to lay the tax on that very kind of activity—production of common goods for shared enjoyment—even if the common goods produced by private philanthropic institutions differ substantially from the ones the Government would purchase or produce in the absence of such institutions.[108]

Charity by the Idle Rich

The discussion thus far has dealt with a taxpayer who contributes part of his earnings to a charitable organization, and it has been pointed out that the effect of the deduction is to treat such a taxpayer as if he had devoted part of his energies directly toward the promotion of charitable enterprises, instead of earning money. Many charitable contributions, however, are made by wealthy people from accumulated wealth or unearned income. Thus, the question arises whether a deduction for them can be justified on grounds such as those we have been exploring.

1. *Contributions Out of Investment Income.*—Consider first a taxpayer with an income solely from dividends who contributes one third to charity and lives on the rest. It cannot be argued very directly that a charitable deduction will operate to treat him as if he were performing services for the charity instead of earning money and turning it over, since he is not earning any money in any event. Nor can it be argued in this situation that the incentive effect of the charitable contribution deduction serves to offset the disincentive effect of the tax on remunerative employment. There may seem to be more reason, therefore, to take the taxpayer's income as fixed and to tax it without regard to use in order to make the tax neutral with respect to expenditure choices.

But I think the deduction is still justified along the lines indicated in this paper for two reasons. First, most taxpayers in the long run do face earnings or investment decisions with respect to which the tax is not neutral and which may have some relation to their level of charitable giving. The deduction will therefore operate to offset the bias of the tax itself insofar as income is devoted to charitable uses. Second, even if that is not so for a particular taxpayer, considerations of equity require that he be allowed a charitable contribution deduction if other taxpayers are. For reasons that include a consideration of incentive effects on most taxpayers, we have decided that taxable consumption should embrace only private, preclusive, household consumption. To make income a measure of consumption thus defined, plus accumulation, a deduction must be allowed for expenditures for other things, whatever the source of the income. The deduction should be allowed, therefore, whenever charitable contributions are made out of taxable ordinary income, whether earned or unearned.

2. *Unrealized Capital Appreciation.*—In the case of a donation of appreciated capital assets to a charitable organization, present law generally allows a deduction for fair market value without taking into account that there is unrealized gain represented by the excess of fair market value over the taxpayer's basis.[109] The argument in this paper will not support that rule. The argument here is concerned only with adjusting gross income to make it a more accurate measure of private consumption plus accumulation by allowing a deduction to offset the inclusion in gross income of receipts that have been turned over to philanthropic use. Since the effect of the fair market value rule is to allow a tax deduction for an amount, the unrealized gain, that will never be included in gross income, it clearly goes beyond that rationale.

Whatever its origin,[110] the fair market value rule must now be viewed as a subsidy or artificial inducement, above and beyond mere tax exemption, for philanthropic giving. The magnitude of the subsidy is a function of the amount of unrealized appreciation in relation to the basis of the property and the taxpayer's rates of tax, being greatest for taxpayers in highest brackets and with most appreciation. For a taxpayer in the top rate brackets whose property has a nominal basis, the rule operates in a sense to make the Government take over the whole cost of a charitable donation. Indeed, the taxpayer will sometimes have more left after taxes for private consumption and accumulation if he donates the property than if he sells it.[111]

3. *Realized Capital Gains.*—There are problems in applying the rationale developed in this paper even when charitable contributions are made out of *realized* long-term capital gains. Consider a taxpayer whose only income is $100,000 of long-term capital gains and who makes charitable contributions in the amount of $25,000. Under present law he will have a long-term capital gain deduction of $50,000 and a charitable contribution deduction of $25,000, leaving taxable income of $25,000 less exemptions and any other deductions. He will thus have left to consume or accumulate $75,000 minus taxes on $25,000. The disparity between a tax on $75,000 and on $25,000 is not, of course, all due to the charitable contribution deduction. The capital gain deduction would by itself reduce the tax on $75,000 of long-term capital gain to that for taxable income of $37,500. But the further reduction to the tax on $25,000 is attributable to the charitable contribution deduction. That reduction is not supported by the rationale advanced in this paper, which merely justifies treating a taxpayer as if he never received a portion of his income equal to what he turns over to charity. It does not support the allowance of both a charitable contribution deduction and a capital gain deduction with respect to the same receipt.

The effect would be more dramatic without the present limitation of the charitable contribution deduction to 50% of adjusted gross income. A taxpayer with $100,000 of long-term capital gains could then give $50,000 to charity and consume or accumulate the other $50,000 without paying any tax at all. The existing limitation of the charitable contribution deduction to 50% of adjusted gross income would leave taxable income of $25,000 in this case, which is arguably the correct result for the current year since it is what the taxpayer would have had if he only received $50,000 of long-term capital gain for his private use in the first place. But the percentage limitation is a crude way of reaching the right result.[112] A better way would be to require that capital gains be reduced by the amount of the donation before computing the capital gain deduction. Of course, when a taxpayer has both capital gains and ordinary income some method would be needed for allocating the contribution between types of income.[113]

4. *Contributions Out of Accumulated Wealth Generally.*—Suppose a taxpayer with a portfolio of bonds that have not appreciated above cost receives $50,000 of interest income and donates bonds worth $25,000 to his alma mater. Under present law he would pay tax on a taxable income of $25,000, though he may live at a $50,000 standard of living. Is there anything wrong with that result?

An interesting contrast is provided by the tax rules governing trusts. If the bonds were held in trust under terms requiring distribution of interest income to an individual beneficiary but requiring or permitting the trustee to make charitable contributions out of corpus, the beneficiary's taxable income would remain at $50,000 despite the contribution.[114] Current consumable income is not reduced by the amount of the contribution out of corpus, and neither is the tax. If the purpose of the charitable contribution deduction is to facilitate an indirect measurement of private, household consumption, then arguably a similar rule should be applied in the case of securities owned individually rather than in trust.

Of course, accumulated funds may have been taxed when earned, and then in theory a charitable deduction may be defended as a kind of device to refund the prior tax. But in many cases the funds accumulated may have been taxed at less than current rates of ordinary income tax or not at all.[115] Still, it would be very difficult to try to ascertain whether accumulated funds have actually been taxed and at what rate. Moreover, any attempt to limit the effect of the charitable contribution deduction to a refund of taxes previously paid would not be easy to reconcile with the fact that we permit a taxpayer to finance current consumption out of accumulated funds, free of current tax, without any investigation of what taxes the accumulation of those funds actually bore.

5. *Conclusion.*—In general, then, the agrument of this paper, that the purpose of the deduction is to help create an income tax that imposes a uniform graduated burden on aggregate personal private consumption and accumulation, supports a deduction for contributions only to the extent that funds out of which each contribution is made have otherwise been included in computing taxable income. That limitation is clearly exceeded in the case of the deduction of fair market value of appreciated capital assets without recognition of the unrealized gain. It raises difficulties in other cases where some current receipts or prior accumulations may have been taxed at less than current ordinary rates. But the difficulties are not solely, or even primarily, a product of the charitable contribution deduction, since they already exist with respect to capital gains or prior accumulations that may be devoted to current private consumption without ever bearing tax at current ordinary income rates. The capital gain rules in particular are themselves inconsistent with the underlying thesis that the tax should be evenly laid on total consumption plus accumulation without distinctions according to differences in source, and the charitable contribution deduction only puts that inconsistency into sharper focus.

IV

SUMMARY AND IMPLICATIONS

The justifications developed here for the medical expense and charitable contribution deductions are quite different from one another. Indeed, to some extent the reasons for allowing a charitable contribution deduction vary among different kinds of contributions. Personal consumption is a complex and ambiguous concept. Accordingly, the precise rationale for ultimately deciding to exclude or include particular items in taxable consumption can be expected to vary widely. But there are a few general strands in the reasoning whose implications are worth noting.

Uses and Sources of Income

Income should ultimately be defined and differentiated for personal tax purposes by its uses, not its sources. The intended primary effect of a direct personal tax is to curtail private consumption of economic resources needed for public use. Income used or kept available for such consumption should be subject to tax, whatever its source. To be sure, there may be some uses of resources, such as those represented by medical care and philanthropy, that merit exemption from tax, but it is the use, not the source, that merits exemption. For example, if a person is not to be taxed on medical care provided by a tortfeasor who caused his injury, then neither should he be taxed on medical care supplied by his employer or paid for out of cash income received by him from other sources.

Simons' definition of personal income as personal consumption plus accumulation makes this point. It was intended to advance the notion that income is not to be defined or differentiated by source. The corollary that income *is* to be defined by uses is a clear and literal implication of this definition, even if unintended and often overlooked. This implication can be made more explicit by transforming Simons' definition into the teleological assertion that the personal income tax is an indirectly measured tax on personal consumption and accumulation. Questions of what constitutes consumption, and of how and when to take accumulation into account, are the essential questions that Simons' definition correctly puts at the center of personal income tax policy formulation.

It follows that personal income tax provisions that differentiate according to how people use their funds (or other resources) deserve careful examination and evaluation to determine whether they further the goal of imposing a uniform, graduated tax burden on aggregate personal consumption and accumulation. On the other hand, those provisions that distinguish according to source must be justified by reference to criteria extraneous to the primary goal of a personal income tax.

The interest deduction may be justifiable, for example, as a matter of personal tax equity, if interest paid can sensibly be excluded in measuring personal consumption. Similarly, there is a case to be made for deducting state and local taxes. Funds spent for either interest or taxes are not available for bread, wine, or travel. If differences in amounts spent for these items do not reflect differences in standards of living,[116] then a deduction would be quite proper.

The exclusion of municipal bond interest,[117] on the other hand, since it depends on source, not on use of funds, cannot be justified as a matter of tax equity. Municipal bond interest is just as available for bread, wine, or travel (or the payment of income taxes) as income from any other source. The exclusion can be justified, therefore, if at all, only as a form of subsidy that must be intended ultimately to benefit municipal borrowers. The tax expenditure analysis represents a perfectly sound way of appraising and criticizing this provision.[118]

Of course, not every differentiation the personal income tax makes among uses of funds is sound. Indeed, one virtue of the tax is its relative neutrality with respect to consumer choices. That virtue will be best preserved if distinctions among uses of income are kept to a minimum. But all such distinctions cannot be ruled out as a matter of principle, and the question of which distinctions to make is one of the unavoidable, central questions of personal income tax policy.

Furthermore, it is not always immediately clear whether a differentiation is one of source or use (or both). In some instances, just as income provides an indirect measure of expenditure, source differentiations provide an indirect indication of important, relevant distinctions in use of resources. In these instances, accordingly, the same considerations utilized to evaluate deductions based directly on use of funds should be employed to determine whether these indirect use distinctions are justified. An earned income credit, for example, is on its face a source distinction, differentiating between earned and unearned income. But a strong case can be made for such a differentiation on the ground that it indirectly reflects an important difference in use or consumption of economic resources. If one person earns $10,000 while another receives $10,000 from investments, they have the same money income and may spend it for the same consumer goods and services, but the investor also has his own time and energy left for whatever he wants to do with them. The earner, on the other hand, has devoted his working hours to the production of goods or services for use by others. That difference in use of time and energy, while not easy to value precisely in monetary terms, is arguably better reflected even crudely than left out of account altogether. An earned income credit would provide just such a crude reflection, by reducing the tax on the earner as compared with the investor.

Another case where source distinctions may reflect important differences in use, but with even less accuracy, is that of capital gains. Many of the arguments for favored treatment of capital gains have to do with uses: capital gains are somehow not as available for spending on consumption as ordinary income items are;[119] or capital gains do not represent any real accumulation because they only offset inflation.[120] But those arguments fail to support our present law because it is not drawn in terms of such limitations or assumptions as to use of funds. Favored treatment is awarded to gains classified as long-term capital gains on the basis of source and form of realization, whatever they are used for. Tax conscious investors and their advisors have thus been able to design ways to live off capital gains or to use capital gains to finance payment of fully deductible expenses. The argument in this paper suggests that if favorable treatment is justified for capital gains at all, it should be applied only after consideration of actual use, rather than on the basis of assumptions that are only sometimes true about what capital gains are generally used for. Instead of taxing capital gains at lower rates because they are supposed to be unavailable for current consumption, we should consider taxing gains of any kind less heavily if they are not in fact devoted to current consumption.

Still another instance of a source distinction that imperfectly reflects use differences is the exclusion of borrowed funds from income. The accepted reason for excluding borrowed funds concerns their source; since borrowing proceeds are acquired only by incurring an obligation to repay, they do not represent any gain. A better justification for the exclusion has to do with uses of funds and with simple convenience of tax administration. Small consumer loans can be left out of account for the latter reason; the only underlying issue is one of timing over a relatively short period. It is simply easier to leave both loan proceeds and repayment out of account.[121] On the other hand, substantial borrowing is generally used to finance capital investments and is not usually available for simple, immediate consumption. Neither does it represent accumulation by the borrower since, to the extent of the borrowing, the accumulation represented by the capital investment is that of the lender.

Basing the exclusion on this set of considerations is important when substantial borrowing is available for consumption. That occurs when borrowing proceeds exceed the cost (though usually not the value) of the investment to which they relate—in cases of borrowing in excess of basis. If the exemption of borrowing proceeds were conditioned upon a consideration of their actual use (or actual use of an equivalent amount of money if the borrowing proceeds themselves were not traced), we would impose a tax in such cases, as indeed we should.[122]

Syndicated tax shelter investments[123] represent the results of source identification run rampant. Borrowing proceeds are excluded from income while a deduction is allowed for various expenses, despite the use of those proceeds to meet these expenses; in addition, income from sources subject to depreciation or depletion is treated as such, despite its use in large part to make deductible interest payments. The result is an excess of deductions over income in both the investing and operating phases, which will be made up only imperfectly, if at all, upon liquidation.[124] If income were classified primarily according to its uses rather than its sources, then investors in syndicated drilling or housing partnerships would be taxed more nearly in accordance with their net cash flow. And the net cash flow is a much better measure of the substance of their investment results than is provided by an internal accounting of the drilling or housing operation.[125]

As these examples make clear,[126] the general notion of defining and differentiating taxable income according to uses rather than sources does not provide pat answers. It does, however, provide an illuminating perspective for reexamination of many of the most difficult problems of tax policy.

Business and Household Activities

Similarly, the notion that a personal income tax should seek to tax aggregate personal consumption plus accumulation casts light on the way business and household activities should be treated. Taxable income is computed by first ascertaining the net result of business and investment activity. It is easy to infer that business and investment activity is the ultimate object of the tax and that adjustments that reflect only differences in household consumption activity are extraneous to the central idea of the tax. But reflection about the purpose of the tax indicates that the truth is just the opposite: the fundamental, underlying object of the tax is household consumption and accumulation. Differences in household consumption activity are, therefore, ultimately the relevant differences to be taken into account in allocating tax burdens. Indeed, business and investment activity enters into the computation of the tax only because the net result of business and investment activity provides the sole convenient way of measuring overall household consumption activity.

To some extent this is just a matter of looking at the other side of the same coin. For example, if travel and entertainment expenses are incurred for business reasons and not for personal pleasure, they are deductible. If they are incurred for personal pleasure not sufficiently connected with business, they are not deductible. We reach the same result whether we say that a deduction will be allowed only for a business expenditure or that a deduction will not be allowed for a personal expenditure.

But in practice people's business and personal activities are often intertwined. This means that it may make an important difference which side we approach the problem from. If we think of the tax as having fundamentally to do with taxpayers in their business capacity, then a sufficient business connection will justify a deduction, whatever personal pleasure may be involved.[127] However, if we think of the tax as having ultimately to do with consumption, then a deduction should be disallowed if the personal benefit from the expenditure is clear and substantial, whatever its business utility. Of course, there is a practical difficulty in fixing the value of the personal benefit in the case of travel or entertainment that might not have been undertaken but for its business connection. Nevertheless, altering our perspective provides substantial justification for rules that would go further than we now do to require inclusion in someone's tax base of items whose business utility depends on their being personally pleasurable to someone, such as entertainment rather categorically defined.[128]

Or consider the interest deduction. It is widely agreed that interest paid on a business debt should be deductible. There is no such agreement with respect to interest on personal debts. It is sometimes apparently assumed that in theory interest on personal debts should be nondeductible, but that in practice it would be difficult to distinguish business from personal debts. Furthermore, any attempt at such a distinction would invite evasion by some taxpayers who would borrow on their business or investment assets to refinance their personal loans.[129]

The present discussion suggests a more significant reason for treating business and personal interest payments alike, even if they could be differentiated: the difference between business and personal interest payments is not one that reflects any real difference in household consumption activity.[130] As mentioned earlier, money paid for interest is unavailable for food, wine, or entertainment whether the debt is business connected or not. So far as a taxpayer's personal standard of living is concerned, it makes no difference whether interest payments are on business loans or personal loans. Therefore, his tax liability should not be affected by that distinction.

A final example concerns the child care allowance.[131] There is a tendency to think of that provision as a special subsidy, notwithstanding the connection between child care costs and the mother's employment, because child care itself seems intrinsically to be a personal, household matter rather than a business activity.[132] But that is an erroneous line of criticism, whatever one may think of the present provision: the reason for allowing the deduction has to do with the working mother's loss of time to devote to household tasks as compared with the nonworking mother, which is precisely the kind of household difference that ought to be taken into account in allocating personal tax burdens.[133]

Consumption and Accumulation

Henry Simons taught us that taxable personal income should be defined as the aggregate of personal consumption plus accumulation without regard to source. That formulation requires us to consider and elaborate what we mean by taxable consumption and accumulation. In this paper we have explored how two of the personal deduction provisions contribute to a rational elaboration of the notion of taxable consumption. Other elements that might be useful in an elaboration of that notion—particularly an earned income credit—have also been suggested.

A similar exploration of the notion of accumulation is needed. Accumulation has this in common with consumption: if we try to begin to list everything that theoretically ought to be included in the concept, we will quickly pass the bounds of any practical scheme of taxation. Accumulation in kind could be construed to include unrealized appreciation in listed securities; in unlisted securities of a close corporation; in a partnership or proprietorship, which could or could not be incorporated; in a patent; in an invention not yet reduced to practice; and so forth. It is not even feasible to make any complete separation between material and human wealth. However, if we open the door to assessing the appreciation in value of human wealth, then there is no logical stopping place short of making graduation from Princeton or an advantageous marriage, or the preliminaries to either of these, substantial taxable events.

Accumulation, on the other hand, will reveal itself to be different from consumption in two important respects. First, the inclusion of an item of accumulation in income is primarily a matter of timing; exclusion is a question of deferral rather than forgiveness of tax.[134] If we taxed an investor on unrealized appreciation, we would not tax him again on realization. If we do not tax Princetonians on graduation, it is only a matter of waiting to see if their prospects actually materialize. In contrast, consumption must be taxed currently or not at all.

Second, it is probable that savings out of cash income are not nearly as satisfactory a surrogate for total accumulation as are personal consumption expenditures for total personal consumption. Unrealized capital appreciation represents a very substantial element in total accumulation,[135] as do accumulated retirement benefits, vested and contingent, of various kinds. Moreover, there is no warrant for assuming, as in the case of imputed income from services and leisure, that these may be more or less evenly distributed within income classes.

If we do indeed adopt the view that the personal income tax is fundamentally a tax on uses rather than sources, then the differences between consumption and accumulation may come to outweigh the similarities. From a household point of view consumption and accumulation are hardly parts of a single quantity; they are more nearly opposites that only happen to add together to equal something else. The fact that consumption plus accumulation equals income is no more warrant for taxing accumulation and consumption together than is the fact that liabilities plus proprietorship equal assets a reason for treating liabilities and proprietorship as parts of the same thing. From the standpoint of evaluating net worth they are the converse of one another.

Notable economists and philosophers have argued that ideally a personal tax should be laid on aggregate personal consumption only, not on total income.[136] Those arguments have too often been overlooked, largely on the assumption that a tax on personal consumption would not be as practical as one on total income or on the ground that we already have a personal income tax and that it would be imprudent to abandon the best thing we have for something else new and untried.

This is not the place for a reevaluation of those arguments, but it may be in order to close by indicating briefly how the present discussion of personal deductions might bear on the question. First, our discussion shows just how feasible it is to remove an item from taxation by way of a deduction. A deduction for personal savings or accumulation expenditures would give us a graduated personal consumption tax without much more difficulty than that involved in allowing deductions for medical expenses and charitable contributions.[137] This discussion shows that we already use income as an operative starting point for measuring and laying a tax on certain of the things income is used for. If we can understand that we are already somewhat selective about what uses of funds enter into our income tax base (by *not* being allowed as deductions), it may appear less radical to suggest that we be just somewhat more selective by deducting out another category of expenditures, those for saving or accumulation.

Second, the present discussion indicates that the tax might be simpler to administer if accumulation were deducted out. Several of the particular problem areas noted in this paper have to do with accumulation and disaccumulation: capital gains,[138] borrowing in excess of basis,[139] charitable contributions out of accumulated wealth.[140] If accumulation were deducted out, then it would be feasible and appropriate to tax all net disaccumulation as ordinary income, just like any other source of consumption.

Third, the present personal income tax is in theory an accretion-oriented income tax in which income transactions are supposed to be used to measure total personal consumption and accumulation. If we can recognize that accretion already has to do essentially with uses rather than sources of funds, it may be easier to imagine how readily the tax could be transformed into a more explicitly consumption-oriented personal income tax in which personal income transactions would be used as the operating base for a tax tailored ultimately to reflect aggregate current personal consumption without accumulation.

Finally, we ought to inquire more closely into what we actually have at present, by considering whether personal accumulation expenditures provide an accurate reflection of aggregate real accumulation. While present theory tells us we have an accretion-oriented tax, if unrealized capital appreciation and other untaxed accruals account for a major fraction of total real accumulation, then in practice what we already have may be nearer to a consumption-type personal income tax than to an accretion-type tax. In that case we should consider whether we could achieve greater fairness by aiming the tax more explicitly at current consumption with an evenhanded deferral of tax on all accumulated gains, whatever their form and source.

The question of taxing accumulation, in short, needs comprehensive reappraisal both in terms of how it is fairest to apportion tax burdens and in terms of what it is most feasible to make personal income transactions measure.

Footnotes

1. *See generally*, Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970). In recent years the Treasury Department has prepared a tax expenditure budget showing the revenue costs of various provisions of the tax law as if they were direct government expenditures. See HOUSE COMM. ON WAYS AND MEANS, 92D CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES (Prelim. Comm. Print 1972) (prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation) [hereinafter cited as TAX EXPENDITURE BUDGET—1971]; 1968 SEC'Y TREAS. ANN. REP. ON THE STATE OF THE FINANCES 326-40 (initial compilation). For criticism of the tax espenditure budget concept see Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969); Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey & Hellmuth*, 22 NAT'L TAX J. 538 (1969). For a recent popularization of the concept see Stern, *Uncle Sam's Welfare Program—For the Rich*, N.Y. Times, April 16, 1972, § 6 (Magazine), at 28.

In recent discussion the term *tax incentives* has sometimes been used rather than *tax expenditures*. *Tax incentive* focuses on the purpose to influence private behavior, while *tax expenditure* would include also provisions whose purpose is relief rather than influence. *See* TAX INSTITUTE OF AMERICA, TAX INCENTIVES (1971); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

A more generally pejorative term is *tax preference* which simply indicates any departure from a norm that the writer implicitly identifies as an ideal or goal to guide the making of tax policy. *See generally* Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967); Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967); Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the*

ABA's CSTR, 81 HARV. L. REV. 1016 (1968); Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968). All of these articles, as well as another round of replies, are reprinted in BITTKER, GALVIN, MUSGRAVE & PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968). *See also* Aaron, *What Is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543 (1969).

2. *See, e.g.*, TAX EXPENDITURE BUDGET—1971, at 5; Surrey, *Federal Income Tax Reform*, *supra* note I, at 369; White, *Proper Income Tax Treatment of Deductions for Personal Expense*, in I HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM 365, 369-70 (Comm. Print 1959).

3. *See, e.g.*, R. GOODE, THE INDIVIDUAL INCOME TAX 169-70 (1964); TAX EXPENDITURE BUDGET—1971, at 5; Surrey, *Federal Income Tax Reform*, *supra* note I, at 381-94; White, *supra* note 2, at 370-71. *See generally* TAX INSTITUTE OF AMERICA, TAX IMPACTS ON PHILANTHROPY (1972).

4. Some tax provisions, like the investment credit, provide an offset against tax liability instead of a deduction or exclusion in computing taxable income. The benefit of these provisions, of course, is distributed among taxpayers without regard to their marginal rate brackets. Still, these provisions are commonly included in lists of tax expenditures, and they illustrate some secondary objections to the use of tax provisions to further extraneous purposes, beyond dependence on graduated tax rates. First, the relief provided by a credit is usually confined to persons who would otherwise have a positive tax liability, no refund being provided if the credit exceeds the tax. Moreover, a credit, like any other tax provision, tends not to be subjected to the same budgetary and appropriations procedures as are applied to equivalent direct expenditure programs. In a survey of the whole subject of tax expenditures this last consideration might well be identified as the most general objection to tax expenditures as *such*, dependence on graduated rates being identified only with a particular form of tax expenditure, namely a deduction or exclusion entering into the computation of taxable income. See Surrey, *Tax Incentives*, *supra* note 1, at 720, 726-32.

In this paper, however, I am concerned to show how personal deductions can be justified as *such*, and as to this showing, interaction with the graduated rate schedule is the central problem. Our showing must be, in Surrey's words, that these provisions can reasonably be "considered a proper and necessary part of the structure of an income tax." *Id.* at 724. From this showing it will follow as a matter of course that benefits are confined to taxpayers and that the legislative consideration should be as part of the taxing rather than the spending process (if the two are to be separated from one another at all).

5. *See, e.g.*, Surrey, *Tax Incentives—Conceptual Criteria for Identification and Comparison with Direct Government Expenditures*, in TAX INCENTIVES, *supra* note 1, at 3 (definitional criteria for tax expenditures).

6. *Cf.* BITTKER, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, *supra* note 1.

7. H. SIMONS, PERSONAL INCOME TAXATION (1938) [hereinafter cited as PERSONAL INCOME TAXATION]. The more elaborate and familiar formulation of Simons' definition is quoted at pp. 2169 *infra*.

8. PERSONAL INCOME TAXATION 51-55, 110-24; see pp. 2169-61 *infra*.

9. In general, Simons was for "taxation of persons according to their periodic accretion of means, and with relatively little regard for the manner in which the means are employed." PERSONAL INCOME TAXATION 139. In particular, he seems to have disapproved of the charitable contribution deduction. *Id.* at 140-41. But this part of his argument was peripheral to the main point, which was a rejection of distinctions among sources of income. See note 12 *infra*.

10. Some lawyers have found Simons' definition, among others, to be of limited use.

> The economists have devoted a great deal of thought to the definition of the concept of income, but it must be confessed that it is difficult for a lawyer to get much concrete aid from their work. Whether this is because of the deficiencies of the definitions or the inadequacies of legal training, or because of the impossibility of treating such a question by definition, may be questioned.

E. GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION 146 (6th ed. 1966). Perhaps the difficulty arises from a difference in the role of definition in economic and legal discourse. In economic discourse Simons' definition functions as a description of a model of economic behavior in which simplification has eliminated ambiguous instances. To be useful in legal discourse the definition must be reinterpreted as a specification of purpose that will illuminate those ambiguous instances. That is what I have tried to do with Simons' definition in this paper.

11. One exception involves the distinction between earned and unearned income which does reflect a consumption difference due to the sacrifice of leisure which earned income entails. Thus, an earned income credit, which seems to distinguish income items according to source, may be perfectly compatible with Simons' definition. He so intimated. PERSONAL INCOME TAXATION at 111; *see* pp. 2170-71, 2186, 2201-02 *infra*.

12. "Any exemption of receipts by kind is clearly incompatible with the essential rationale of income taxes." PERSONAL INCOME TAXATION 170. The main points in Simons' program were to tax gratuitous receipts, capital gains in full including unrealized gains at death, tax-exempt interest, and imputed rent.

13. *See* Surrey, *Federal Income Tax Reform*, *supra* note 1, at 371-81.

14. *See* pp. 2204-06 *infra*.

15. *See, e.g.*, PERSONAL INCOME TAXATION 50, quoted at pp. 2169 *infra*.

16. Section 22(a) of the Internal Revenue Code of 1939, ch. 2, § 22(a), 53 Stat. 9, provided that "gross income" included "gains, profits, and income from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid . . . ." Section 61(a) of the present Code omits the phrase "in whatever form paid." However, the Senate Finance Committee said that while "the section 22(a) phrase 'in whatever form paid' has been eliminated, statutory gross income will continue to include income realized in any form." S. REP. NO. 1622, 83d Cong., 2d Sess. 168 (1954).

17. This was roughly the definition adopted by the Supreme Court in Eisner v. Macomber, 252 U.S. 189, 207 (1920):

> "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets.

Any attempt at systematic definition was later abandoned. *See* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

18. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 526 (1955).

19. *See* pp. 2173-75 *infra*.

20. *See* Haig, *The Concept of Income*, in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921), *reprinted in* AMERICAN ECONOMICS ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54 (R. Musgrave & C. Shoup eds. 1959) (emphasis in original): "Income is the *money value of the net accretion to one's economic power bewteen two points of time*."

21. PERSONAL INCOME TAXATION 61.

22. *Id.* at 50.

23. *Id.* at 170-84.

24. *Id.* at 148-69.

25. *Id.* at 125-47. Simons later retreated from the idea of taxing gifts as income, but continued to urge inclusion of municipal bond interest and capital gains in full. H. SIMONS, FEDERAL TAX REFORM 34-38, 44 (1950).

26. PERSONAL INCOME TAXATION 51-55, 110-24.

27. *Id.* at 53.

28. *Cf.* OFFICE OF BUSINESS ECONOMICS, U.S. DEP'T OF COMMERCE, NATIONAL INCOME 1954 EDITION, A SUPPLEMENT TO THE SURVEY OF CURRENT BUSINESS 38 (1954):

> No precise line can be drawn between final and intermediate products from mere observation of the nature of the products or the uses to which they are put. It would be easy, for example, if all consumer purchases were for goods like Sunday clothes and holiday dinners, which are obvious elements of the good life, and if all business purchases were raw materials for further processing, which are obvious intermediate goods. Between these two extremes, however, there is a wide range of purchases for which neither the motivation nor the use is so clear-cut and which must be placed in one category or the other by somewhat arbitrary rules.
>
> For this reason any measure of total production must be somewhat conventional. For instance, it must overlook the fact that the expenditures of individuals in their business capacity are influenced by their standards as consumers, and that expenditures of consumers are influenced by their activities as producers. It must overlook also the fact that the conditions under which work is performed have an important bearing on the welfare of individuals. These conditions are affected by business expenditures on goods and services that are classified as intermediate just because there is no satisfactory way to take account of the benefits in a quantitative measure of final output.

29. See Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip — A Conceptual Analysis*, 18 STAN. L. REV. 1099 (1966); *cf.* Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967).

30. R. GOODE, *supra* note 3, at 120-29; PERSONAL INCOME TAXATION 112; Aaron, *Income Taxes and Housing*, 60 AM. ECON. REV. 789 (1970).

31. Consider two brothers each earning $15,000 a year. A trust is created under which each brother begins to receive a $15,000 income. One brother continues to work and raises his level of expenditures for personal travel and entertainment; the other quits work in order to have more time to travel and to entertain himself. Surely both men are better off after creation of the trust than before, and arguably by a comparable amount. Yet only the first brother's income taxes would increase under our present law. If we had an earned income credit, the second brother's tax would go up too—though presumably not as much as the first brother's.

32. PERSONAL INCOME TAXATION 112-18.

33. *Id.* at 110-11, 113.

34. *Id.* at 52, 111.

35. See *id.* at 111. Congress twice experimented with an earned income credit. See Revenue Act of 1924, ch. 234, § 209(b), 43 Stat. 264 (repealed by Revenue Act of 1932, ch. 209, 47 Stat. 169); Revenue Act of 1934, ch. 277, § 25(a)(4), 48 Stat. 692 (repealed by Revenue Act of 1943, ch. 63, § 107(a), 58 Stat. 31).

36. See PERSONAL INCOME TAXATION 139-41.

37. Without adequate taxes the corresponding reduction in private consumption and accumulation would be imposed and distributed by way of inflation.

38. See PERSONAL INCOME TAXATION 17:

> Tons of paper have been employed in teaching the world that taxes should be levied according to ability—perhaps for the reason that this word utterly defies definition in terms of any base upon which taxes are or ever might be levied. Whereas the question is as to how taxes should be allocated with respect to income, consumption, or net worth, the answer is that they should be proportional to ability or faculty, which cannot be conceived quantitatively or defined in terms of any procedure of measurement. Such an answer indicates that the writer prefers the kind of taxation which he prefers; that he is unwilling to

reveal his tastes or examine them critically; and that he finds useful in his profession a basic "principle" from which, as from a conjurer's hat, anything may be drawn at will.

39. There are a few dissenters. See, e.g., Brown, *The Incidence of a General Output or a General Sales Tax*, 47 J. POL. ECON. 254 (1939); Rolph, *A Proposed Revision of Excise-Tax Theory*, 60 J. POL. ECON. 102 (1952). *See also* D. MORGAN, RETAIL SALES TAX: AN APPRAISAL OF NEW ISSUES, ch. VI (1964).

40. See PERSONAL INCOME TAXATION 38:

> The obvious system of toll charges, however, has been abandoned for good reasons; and the gasoline tax has been hit upon as an excellent device for accomplishing indirectly, and with a minimum of administrative difficulty and personal inconvenience, what it is inexpedient to attempt directly.

41. An unpublished paper by Professor Thomas Schelling suggested this figure and stimulated a good deal of my thought throughout this paper, but in this section in particular. T. Schelling, Accounting Identities, 1970 (presented orally at the Analytic Methods Seminar of the Kennedy School of Government). There is no reason to suppose, however, that Professor Schelling would agree with any of my conclusions.

42. Revenue Act of 1942, ch. 619, § 127, 56 Stat. 825 (now INT. REV. CODE OF 1954, § 213). For analysis of some of the basic problems related to the provision of a medical expense deduction, see C. H. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 126-61 (1960); Fisher, *What Constitutes a Medical Deduction; Medical Dependency; Sick Pay*, 1963 N.Y.U. 21ST INST. ON FED. TAX 169; Jensen, *Rationale of the Medical Deduction*, 7 NAT'L TAX J. 274 (1954); Jensen, *Medical Expenditures and Medical Deduction Plans*, 60 J. POL. ECON. 503 (1952); Comment, *Medical Deduction: Test and Application*, 28 U. CHI. L. REV. 544 (1961).

43. INT. REV. CODE OF 1954, § 213 [INT. REV. CODE OF 1954 hereinafter referred to as CODE]. Expenditures for medicines and drugs count as medical expenses only to the extent they exceed 1% of adjusted gross income. CODE § 213(b). A deduction, up to $150, is allowed for one-half of medical insurance premiums, without regard to the 3% floor. CODE § 213(a)(2). The remainder of medical insurance premiums is deductible along with other medical expenses to the extent they exceed 3% of adjusted gross income. The allowance of part of the premium even below the 3% floor might be justified on the ground that while it may fall below the floor as a premium payment, it is to cover services whose cost likely will exceed 3% of adjusted gross income if the need for them does materialize. For a large group of people under a medical insurance plan, partial deductibility without regard to the floor may operate to make the same portion of total medical costs deductible as would have been deductible without the intervention of an insurance arrangement. In any event, it is clear the Congress wanted to avoid creating or continuing a disincentive to the purchase of medical care insurance. S. REP. NO. 404, 89th Cong., 1st Sess. 154 (1965). On the other hand, the problem of auditing a multitude of individual expenditures, which the 3% floor is in part designed to avoid with regard to most taxpayers, is not significant with respect to an insurance premium. *Cf.* C.H. KAHN, *supra* note 42, at 159.

Our present treatment of casualty losses provides an instructive contrast. One who insures his home against fire or his personal automobile against collision gets no deduction for his premium, although an uninsured loss in either case would be deductible. CODE § 165(c)(3). A rational high bracket taxpayer should consider, therefore, that part of the cost of insuring his own interest in such property is that he must purchase insurance for the tax collector's interest in the property as well. See C.H. KAHN, *supra* note 42, at 158-59.

44. INTERNAL REVENUE SERVICE, PRELIMINARY REPORT, STATISTICS OF INCOME—1970: INDIVIDUAL INCOME TAX RETURNS 22, 40 (1972). For 1968 about one-third of the returns with a medical expense deduction claimed only the one-half of insurance premium deduction. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1968: INDIVIDUAL INCOME TAX RETURNS 76 (1970).

45. 1970 STATISTICS, *supra* note 44, at 22, 40. Medical expenses were 2.4% of total adjusted gross income on returns with itemized deductions.

46. TAX EXPENDITURE BUDGET—1971, at 5.

47. See THE BUDGET OF THE UNITED STATES—FISCAL YEAR 1973, H.R. Doc. No. 92-215, pt. 1, 92d Cong., 2d Sess. 507 (1972) ($86.23 billion actual revenue from individual income tax in 1971).

48. See 1968 STATISTICS, *supra* note 44, at 76.

49. *E.g.*, TAX EXPENDITURE BUDGET—1971, at 5; see Surrey, *Federal Income Tax Reform*, *supra* note 1, at 369.

50. *E.g.*, TAX EXPENDITURE BUDGET—1971, at 5. This item is estimated at $2.0 billion per year, making a total of $3.9 billion for exclusion of medical care from taxable income. The tax expenditure budget also includes other health-related items, such as the sick pay exclusion, estimated at $120 million per year, and the additional exemption for the blind, estimated at $10 million per year. *Id.* at 4.

51. This point raises a question, which I do not propose to try to settle here, about the whole matter of justifying progressive taxes as such on redistributional grounds. It is probably true that a progressive tax will lead to smaller disparities in after-tax income than would a proportional tax designed to raise the same amount of revenue, all other things being unaffected. It is also true that high rates of tax, such as are imposed (nominally) by a graduated rate schedule at higher income levels, will reduce disparities in income more than a tax with lower rates. But a high flat-rate tax coupled with simple income grants to low-income families would apparently produce more income redistribution on the whole, and certainly more among low-income families, than can any progressive tax without income payments to the poor.

52. Similarly, the reasons for personal exemptions, the low income allowance, and lower-than-average rate brackets in the income tax would support and indeed be better served by positive income grants to poor families. In fact, the medical expense deduction can be partly seen as a kind of extension of the idea underlying exemptions and the low-income allowance, reflecting the fact that minimum family needs vary in a measurable way when unusual medical expenses are incurred.

53. The analysis with respect to choices among more and less remunerative jobs, instead of work and leisure, would be essentially the same except that job satisfaction rather than leisure is the good whose price is not raised. The price effect of the tax will be to favor the more satisfying but lower paying job; on the other hand, the income effect may be to make the taxpayer give up the more satisfying job in order to maintain his existing level of purchases of other goods.

54. The Senate Finance Committee recommended the deduction "in consideration of the heavy tax burden that must be borne by individuals during the existing emergency and of the desirability of maintaining the present high level of public health and morale." S. REP. NO. 1631, 77th Cong., 2d Sess. 6 (1942).

55. Bernard & Feingold, *The Impact of Medicaid*, 1970 WIS. L. REV. 726, 745.

56. Occasionally a taxpayer may work overtime to provide a dependent with medical care he otherwise could not afford; the medical expense deduction effectively exempts from tax the extra income so utilized, and thus offsets the normal disincentive to extra work which the tax entails.

57. *Cf.* pp. 2196 *infra*.

58. Act of October 3, 1917, ch. 63, tit. XII, § 1201(2), 40 Stat. 330 (now CODE § 170). For consideration of some of the problems associated with the provision of a deduction for charitable contributions, see C.H. KAHN, *supra* note 42, at 46-91; SYMPOSIUM: TAXATION AND EDUCATION (Proceedings of Special Conf. of American Alumni Council, 1966, R. Finehout ed.); TAX INSTITUTE OF AMERICA, *supra* note 3; Rabin, *Charitable Trusts and Charitable Deductions*, 41 N.Y.U.L. REV. 912 (1966); Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 U. SO. CAL. 1968 TAX INST. 27; Taggart, *The Charitable Deduction*, 26 TAX L. REV. 63 (1970); Taussig, *Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions*, 20 NAT'L TAX J. 1 (1967).

59. CODE § 170(b).

60. CODE §§ 170(a)(3), (b)(1)(D), (e), (f).

61. 1970 STATISTICS, *supra* note 44, at 22, 40.

62. *Id.* Charitable contributions were 2.9% of total adjusted gross income on returns with itemized deductions.

63. TAX EXPENDITURE BUDGET—1971, at 5; *see* 1973 BUDGET, *supra* note 47, at 507.

64. *E.g.*, R. GOODE, *supra* note 3, at 169-70; TAX EXPENDITURE BUDGET—1971, at 5; Surrey, *Federal Income Tax Reform*, *supra* note 1, at 384-85. *See generally* TAX INSTITUTE OF AMERICA, *supra* note 3.

Professor Bittker, however, has made several arguments for viewing the charitable contribution deduction as a legitimate refinement of the notion of taxable income. *See* SYMPOSIUM: TAXATION AND EDUCATION, *supra* note 58, at 29-31; TAX INSTITUTE OF AMERICA, *supra* note 3. *See also* C.H. KAHN, *supra* note 42, at 88-89.

Characterization of the deduction for contributions to religious organizations as a tax expenditure or subsidy has constitutional as well as policy implications. Professors Surrey and McDaniel have asserted that the deduction raises the same constitutional objections as would a program of direct government assistance in the form of matching grants, since in their view the deduction is only another way of making such grants. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 409-11 (1972); Surrey, *Federal Income Tax Reform*, *supra* note 1, at 393 n.68; Surrey, *Tax Incentives*, *supra* note 1, at 714 & n.9; *see* Stone, *Federal Tax Support of Charities and Other Exempt Organizations*, *supra* note 58, at 55. If the deduction can be seen as a rational refinement in the definition of what it is we seek to tax, as is argued in this paper, then it will be easier to defend constitutionally. *Cf.* Walz v. Tax Comm'n, 397 U.S. 664 (1970) (exemption of churches from general property tax does not violate first amendment since tax exemption does not cause same involvement as direct subsidy); Bittker, *Churches, Taxes and the Consitution*, 78 YALE L.J. 1285 (1969) (discussing exemption of churches from various taxes). *But cf.* McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972) (concerning tax exemption for racially discriminatory fraternal order).

65. *See* note 111 *infra*; Surrey, *Federal Income Tax Reform*, *supra* note 1, at 388; *cf.* Rudick & Gray, *Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity*, 16 TAX L. REV. 273 (1961).

66. *See* pp. 2199 *infra*.

67. CODE §§ 1, 151.

68. *See* pp. 2173-75 *supra*.

69. This explanation will not account for the separate taxation of children's property income. Perhaps in general children's property income is accumulated rather than consumed, and accumulation is more of an individual function and less of a household function than consumption. Or perhaps the opportunity to divert some property income to children is just an indirect step in the direction of letting aggregate household tax rates be determined by something nearer per capita rates of income and consumption and accumulation. Perhaps there simply is no adequate explanation for our treatment of children's property income. Indeed, Congress has recently concluded that such income ought to be ineligible for the low income allowance, which is a household consumption concept. *See* CODE § 141(e)(2) (added by Revenue Act of 1971, Pub. L. No. 92-178, § 301(c), 1971 U.S. CODE CONG. & AD. NEWS 577).

70. In 1969 a lower rate schedule was adopted for unmarried taxpayers than for married taxpayers filing separately. CODE §§ 1(c), (d) (amended by Tax Reform Act of 1969, Pub. L. No. 91-172, § 803, 83 Stat. 678). The consequence is that two unmarried persons with approximately equal individual incomes will have a lower total tax burden than a married couple with the same total income. The discussion in the text suggests that what justifies the reduced rate is the fact that both work, not that they are unmarried. It may be the case that unmarried persons are more likely all to hold jobs, while one member of a married couple frequently provides services at home in kind. But that pattern is not universal, and there is no reason for the tax law to be

written to try to make it so. In particular, the tax on two married persons who both have earnings should be no higher than on two unmarried persons with the same income.

Similarly, the low income allowance, as enacted in 1969, and the maximum percentage standard deduction are available only once per couple among the married, but once per person among the unmarried. CODE §§ 141(b), (c), (d) (amended by Tax Reform Act of 1969, Pub. L. No. 91-172, § 802, 83 Stat. 676). It would be better if they were made available once for each employed individual whether married or not.

The child care allowance, made much more generous in 1971, does reflect the loss of child care services performed in kind at home when the last available adult goes to work. CODE § 214 (amended by Revenue Act of 1971, Pub. L. No. 92-178, § 210, 1971 U.S. CODE CONG. & AD. NEWS 574). But care for children under 15, and for other dependents incapable of caring for themselves, is not the only kind of valuable service a housewife quits when she takes a job outside her home.

71. Compare in this respect the Carter Commission Proposals in Canada under which household would have been defined, for the purpose of exempting donative transfers, rather narrowly and precisely in terms of prescribed ages and relationships. Upon reaching majority a child would have been considered to be leaving his parents' household and would have been taxable on whatever property he took with him at that point in time. See I REPORT OF THE ROYAL COMMISSION ON TAXATION 19 (1967); 3 *id.* at 130-39. In 1969 the Government rejected the Commission's proposals for taxing the family as a single unit. See E.J. BENSON, PROPOSALS FOR TAX REFORM 14-15 (1969) (Ministry of Finance White Paper).

72. See, e.g., Havemeyer v. Commissioner, 98 F.2d 706, 707 (2d Cir. 1938) (deduction allowed for contributions to an association which made distributions to persons of whom the court said: "They were mainly, though not entirely, old family retainers and all were needy and worthy.").

73. Having cited Henry Simons in connection with so much of this argument, I must concede the differences between us at this point. He argued that gifts and inheritances ideally should be included in income of the recipient since they support consumption or accumulation, though he sometimes acknowledged that practical considerations would prevent inclusion of every small gift in kind and might require a separate rate schedule and system of cumulation for such items. Furthermore, he recognized but rejected the possible corollary argument that the donor should get a deduction since his consumption and accumulation are reduced by the amount of his gift. PERSONAL INCOME TAXATION 56-58, 125-47, 211-12. Simons' proposal to include gifts in income, without any deduction for the donor, has always seemed to me the weakest part of his program. In his later work Simons himself appears to have backed off from his proposal that gifts be included in income as such, advocating instead "attention to the possibility of replacing the existing Estates and Gift Taxes by a more sensible form of tax on *beneficiaries* of donative transfers." FEDERAL TAX REFORM, *supra* note 25, at 37 (emphasis in original).

Simons seems, moreover, to have disapproved of the charitable contribution deduction. He offered arguments against selective deductibility of worthy donations on the grounds that they all represent personal consumption since they are not for the sake of making money, and that power is the object of the tax. PERSONAL INCOME TAXATION 139-41. But, strangely, he included no explicit denunciation of the existing provision for deducting charitable contributions, and abolition of the deduction did not appear as part of his program. *Id.* at 205-20. His central argument, again, was against distinctions in treatment on account of differences in sources of gains available for consumption or accumulation.

74. A person who devotes full time to domestic chores in his own home may, of course, produce just as much free of tax as he could have earned and been taxed on by doing the same work in someone else's household. But domestic service is a relatively low paying form of work, partly because it does not seem to be as amenable to the economies of specialization as other occupations. Moreover, the performance of domestic services in kind within the household by one adult member of a family is so widespread that the practical thing may be to take it as the norm, and then to try to make some compensating allowance for families without an unemployed adult to keep the house in order. The deduction for child care represents a step in that direction. We might well go further. See note 70 *supra*.

75. A problem may arise in the case of a benefit performance when an entertainer performs for paying patrons under arrangements that provide for the payments to go to charity. If the entertainer has not used up his available charitable contribution limit, it will not generally matter

whether income is imputed to him because if it is there will be an offsetting charitable contribution deduction. When the deduction limit is reached, however, it will make a difference. *But cf.* CODE § 114.

76. "Personal income connotes, broadly, the exercise of control over the use of society's scarce resources." PERSONAL INCOME TAXATION 49. *But compare id.* at 49-50 ("[c]onsumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods)") *with id.* at 57 ("If it is not more pleasant to give than to receive, one may still hesitate to assert that giving is not a form of consumption for the giver.").

77. This argument is more fully developed at pp. 2193-94 *infra.*

78. For some rudimentary speculation about the character of this pleasure or satisfaction see SYMPOSIUM: TAXATION AND EDUCATION, *supra* note 58, at 45-46 (Brazer: "If we assume that the contributor to education realizes a continuing flow of satisfaction from having made his contribution, it is not stretching matters too far to regard his gifts as investments which produce a non-pecuniary, non-taxable yield. They are, in this sense, similar to investments in art objects."); *id.* at 51 (Harriss: "I am more inclined to think that the benefits from contributions, at least the kinds many of us make, are satisfactions which are less lasting, more fleeting, than one gets from the purchase of an art object. A gift of this type is not really an investment for many of us so much as consumption."); *id.* at 60 (White: "Rather, Brazer's assumption that the contributor derives a glow of satisfaction from his contribution seems to me more appropriate."); *id.* at 61 (White, in a slightly different context: "I would like to dwell a little bit further on this relationship between the before and after tax giving, since it seems to me important and some source of confusion at least to me in all of the discussion that we have had so far . . . . The gratification of the pure desire to give seems to me to be fulfilled by an allocation of funds that otherwise would be available to provide utility through consumption or wealth accumulation, which would be after tax income, not before tax.").

These speculations seem to me to confirm the desirability of trying to define taxable income in terms of material benefits to the recipient rather than non-material satisfactions to the donor.

79. See HOUSE COMM. ON WAYS & MEANS, TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS 70 (1965) (table 4); INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1962: INDIVIDUAL INCOME TAX RETURNS 6-8 (1965).

80. Moreover, contributions to educational institutions come much more heavily from high bracket taxpayers than do contributions to churches. See TREASURY DEPARTMENT REPORT, *supra* note 79, at 70.

81. See CODE §§ 71, 215.

82. *Cf.* Hardin, *The Tragedy of the Commons,* 162 SCIENCE 1243 (1968).

83. *Cf.* Aaron, *supra* note 1, discussing the ideal necessity and practical impossibility of including the benefit of public goods in personal income whether produced by government or nongovernment philanthropic institutions.

84. Under certain circumstances some tuition charges are deductible as a business expense. See Treas. Reg. § 1-162-5 (1967) (expenses for education).

85. CODE § 117; *cf.* note 126 *infra.*

86. With regard to the timing of such taxation, *cf.* p. 2205 *infra.*

87. Indeed, a reasonable argument can be made along these lines for allowing a deduction for tuition payments. If the graduate of a first-class state university is to be untaxed on the benefits of his education except as and when they are reflected in earnings, then it is not clear why the graduate of a private university whose tuition covers a larger portion of the cost of his education should be treated differently. The argument has a considerable appeal, especially in the cases of vocationally or professionally oriented training and of students working to put themselves through school. See note 126 *infra; cf.* R. GOODE, *supra* note 3, at 82-93.

88. CODE §§ 1, 151.

89. *Cf.* pp. 2179-80 *supra.*

90. *See generally* M. OLSON, THE LOGIC OF COLLECTIVE ACTION 5-52 (rev. ed. 1971).

91. See C.H. KAHN, *supra* note 42 at 6-7, 46. Senator H.F. Hollis, introducing the original charitable contribution deduction, explained that people usually

> contribute to charities and educational objects out of their surplus. . . . Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize. . . . They will say, "Charity begins at home."

55 CONG. REC. 6728 (1917). For further discussion of the allocative impact of the charitable contribution, see pp. 2198-99 *supra.*

92. See pp. 2172-73, 2188-89 *supra.*

93. See pp. 2189 *supra.*

94. See pp. 2188-89 *supra.*

95. See CODE § 162.

96. CODE §§ 41, 218 (added by Revenue Act of 1971, Pub. L. No. 92-178, §§ 701, 702, 1971 U.S. CODE CONG. & AD. NEWS 628).

97. See Sacks, *The Role of Philanthropy: An Institutional View,* 46 VA. L. REV. 516, 526 (1960).

98. C.H. KAHN, *supra* note 42, at 87-91; W. VICKREY, AGENDA FOR PROGRESSIVE TAXATION 131 (1947); Stone, *supra* note 58, at 47-48; White, *supra* note 2, at 371.

99. McDaniel, *supra* note 64.

100. Indeed, low-income taxpayers performing voluntary philanthropic services could get their taxes reduced under a credit scheme by being paid for their work and then donating the proceeds. Would one who contributed services to charity be permitted to impute their value as income and donation?

101. CODE § 41 provides a credit against tax up to $12.50 per person ($25 on a joint return) for half the amount of political contributions. In the alternative § 218 offers a deduction up to $50 per person ($100 on a joint return) for the full amount of such contributions. Both provisions were added by the Revenue Act of 1971, Pub. L. No. 92-178 §§ 701, 702, 1971 U.S. CODE CONG. & AD. NEWS 628.

102. See pp. 2181-82 *supra.*

103. *Cf.* p. 2173 *supra.*

104. See pp. 2190-92 *supra.*

105. *Cf.* pp. 2187-88 *supra.*

106. The width of the community within which a good must be available for shared or free use has varied for different kinds of services to qualify as charities. See, *e.g.*, Rev. Rul. 67-325, 1967-2 CUM. BULL. 113, denying charitable qualification to an organization providing recreational facilities for all persons of a particular race in a particular community.

> Providing a community recreational facility is in the general class of purposes which are recognized as charitable only where all the members of the community are eligible for direct benefits.

Id. at 115. Other purposes like education

> have been deemed to be beneficial to the community as a whole even though the class or classes of possible beneficiaries eligible to receive a direct benefit from the dedication of property to the particular purpose do not include all the members of the community.

Id. This statement was made while deductions were still allowed for contributions to racially segregated private schools. Although deductions are now disallowed for contributions to racially segregated schools, the grounds for disallowance are more specific: such exemptions are not consonant with federal policy against racial discrimination in schools. The more general point being made in Revenue Ruling 67-325 apparently still holds, therefore. See Green v. Connally, 330 F. Supp. 1150 (D.D.C.), *aff'd sub nom.* Coit v. Green, 404 U.S. 997 (1971) (per curiam); *cf.* McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972) (concerning tax exemption for discriminatory fraternal organization).

See also Rev. Rul. 69-545, 1969-2 CUM. BULL. 117, with respect to how open to the community generally a private hospital must be in order to qualify for tax exemption under CODE § 501(c)(3).

107. See M. OLSON, *supra* note 90, at 13-15.

108. See R. GOODE, *supra* note 3, at 170. President Eliot of Harvard put the matter more strongly in relation to the exemption from state taxes:

> If the State wants the work done, it has but two alternatives—it can do it itself, or it can encourage and help benevolent and public-spirited individuals do it. . . .
>
> . . . It is at once apparent that this objection [to the exemption of institutions of religion, education and charity from taxation] is both illogical and mean; —illogical, because if churches, colleges and hospitals subserve the highest public ends, there is no reason for making them contribute to the inferior public charges, and mean, because it deliberately proposes to use the benevolent affections of the best part of the community as means of getting out of them a very disproportionate share of taxes.

Eliot, *The Exemption from Taxation of Church Property and the Property of Educational and Charitable Institutions*, in EXEMPTION FROM TAXATION IN MASSACHUSETTS 21, 25-26 (1910), quoted in part in E. GRISWOLD, *supra* note 10, at 1075.

109. CODE § 170. There are several limitations on the rule permitting a charitable deduction of the fair market value of the property. These concern property whose sale would have produced gain other than long-term capital gain, CODE § 170(e)(1)(A); tangible personal property whose use by the donee is unrelated to the basis for its exemption, CODE § 170(e)(1)(B)(i); property contributed to certain private foundations, CODE § 170(e)(1)(B)(ii); and property contributed whose value is in excess of 30% of the donor's adjusted gross income in any year. CODE § 170(b)(1)(D).

110. See Law. Op. 1118, II-2 CUM. BULL. 148 (1923).

111. Consider a capital asset held for more than 6 months with a fair market value of $100 and a basis of 0. If a 70% bracket taxpayer donates it, he will get $70 by way of tax reduction. If he sells it for $100, he will have a tax increase of $35 (assuming other long-term capital gains exceed capital losses by $50,000), leaving only $65.

112. The 50% limitation happens to produce the right result in this example only because the figures work out that way. Moreover, the result is not wholly right because the taxpayer will have a carryover of the excess of his contribution over the limitation. CODE § 170(d).

113. In 1969 the Treasury Department proposed a provision for allocating personal deductions in general proportionately between taxable income and tax-exempt income, disallowing the portion allocable to the latter. HOUSE COMM. ON WAYS AND MEANS & SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., U.S. TREASURY DEP'T, TAX REFORM STUDIES AND PROPOSALS 14-15, 35-36, 142-52 (Comm. Print 1969). That proposal is quite consistent with the argument in this paper.

114. See CODE § 662(a)(1).

115. See CODE § 1014.

116. If a taxpayer borrows to finance personal consumption, then it may be asserted that interest expenditures will tend to reflect a difference in standard of living. A complete answer to this assertion would require another paper, but several lines of argument can be suggested. (1) If the assertion refers to situations in which substantial borrowing is likely to represent a long term, tax-free way of financing current personal consumption, then a tax on interest paid on the borrowing (imposed by denying a deduction for the interest payment) is a wholly inadequate way of dealing with the problem. The borrowing proceeds should themselves be taxed. *See* pp. 2202-03 *infra*. (2) Insofar as the assertion implies that a given item of consumption now is worth more than the same item later and that interest is the cost of acceleration of enjoyment, the answer is that the symmetric argument would require exclusion of interest from taxable income, and yet interest income is taxed. A tax on total income, by including accumulation and the interest return on it, reduces the reward for deferring consumption; it is only the other side of the same coin if the interest deduction reduces the cost of accelerating consumption. Furthermore, for an argument that nondeductibility of interest on personal loans would present intractable problems of distinguishing business from personal borrowing, see p. 2204 *infra*. (3) Insofar as the assertion refers specifically to interest on debt incurred to purchase consumer durables like housing, interest expenditures again provide a very inaccurate measure of the consumption involved. A wealthy man who owns his house without a mortgage enjoys just as much current consumption from living in the house as does a less wealthy taxpayer whose house is subject to a mortgage, and the only way to tax that consumption without exempting the wealthy man is to include imputed rental value. The interest deduction itself reflects a real difference between the homeowner with a mortgage and one without. *See* R. GOODE, *supra* note 3, at 128-29; Aaron, *supra* note 30, at 802-04; White, *supra* note 2, at 365-66.

117. CODE § 103.

118. *See* Surrey, *Federal Income Tax Reform*, *supra* note 1, at 371-80.

119. *See, e.g.*, M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 5 (1968).

120. *See, e.g.*, *id.* at 5-6.

121. *Cf.* note 116 *supra*.

122. *But cf.* Woodsam Associates v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (borrowing on appreciated property in excess of basis held not a "disposition," and thus not a taxable transaction). Given the Supreme Court's decision in Crane v. Commissioner, 331 U.S. 1 (1947), that on disposition of property the amount realized includes any debt to which the property was subject, see note 124 *infra*, it is difficult to disagree with the Second Circuit's decision in *Woodsam*. But neither decision should stand after a reexamination of the reasons for exempting borrowing proceeds from tax. *Cf.* McKee, *The Real Estate Tax Shelter: A Computerized Expose*, 57 VA. L. REV. 521, 565 (1971). *See generally* Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966).

123. Tax shelter investments are investments designed to show a loss for tax purposes, at least in the first few years, so that other income will be "sheltered" from tax. In recent years syndication has been accomplished by organizing such investments in partnership form and selling limited partnership interests to the public. *See, e.g.*, 1 S. SURREY, W. WARREN, P. McDANIEL & H. AULT, FEDERAL INCOME TAXATION: CASES AND MATERIALS 413-94 (1972).

124. Crane v. Commissioner, 331 U.S. 1 (1947), held that on disposition of property a debt to which the property was subject is part of the amount realized. This has the effect of restoring to gross income prior deductions financed with the borrowing proceeds if they were accompanied by appropriate basis deductions. But sometimes, as in the case of percentage depletion, the deduction may not have been accompanied by a basis adjustment. And because of imperfect recapture rules the restoration to income may be largely as long-term capital gain rather than ordinary income. See CODE § 1250. Finally, even when recapture at ordinary income rates is complete, the deferral of tax that results from early deductions and later recovery may dramatically lower the effective rate of tax on a highly leveraged investment. See McKee, *supra* note 122, at 541-47.

125. Another instance of distortion due to characterization of receipts by an internal accounting by source instead of by cash flow or use arises from the requirement that there be profits to characterize a corporate distribution as a dividend. One result, until recently, was to enable some companies, by charging for accelerated depreciation, not only to defer corporate taxes but also to secure return-of-capital status for all or part of their regular recurring cash dividends. The 1969 Tax Reform Act attempted to deal with this problem. *See* CODE § 312(m) (added by Tax Reform Act of 1969, Pub. L. No. 91-172, § 442(a), 83 Stat. 628). *See generally* Andrews, *"Out of Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956).

126. Yet another example of confusion between sources and uses of funds is the exclusion of ordinary scholarship awards from income. CODE § 117. The best reasons for excluding scholarship awards are that they generally go to relatively needy students to meet tuition costs and moderate living costs while attending school and that we would not want the income tax to impair the fulfillment of the objective of the grant. *Cf.* pp. 359-60 *supra*. But these reasons could be more accurately reflected in a deduction for those uses of funds than in an exclusion of funds derived from a particular source. The personal exemption and low income allowance provisions are already designed to provide for minimum living costs free of income tax for all taxpayers, whatever the source of the income; it is hard to see why students should have any higher standard of living tax-free. A deduction for tuition, books, and any other direct educational costs could be allowed in addition to the personal exemption and low income allowance, *cf.* note 87 *supra*, and would presumably nearly eliminate any income tax for most needy scholarship students, even if their scholarship award were included in gross income. Relief might even be confined to relatively needy students, if that were desired, by allowing the deduction for tuition only against earned income of the student himself, as is now the case with the low income allowance, and by treating scholarship grants as equivalent to earned income.

Such a change in the rules covering scholarship students would have at least these three clear advantages. (1) It would cause scholarship awards to enter into income in cases where they exceed educational costs or supplement other income that exceeds educational costs. *See generally* Myers, *Tax Status of Scholarships and Fellowships*, 22 TAX LAWYER 391 (1969); Randall, *Athletic Scholarships and Taxes: Or A Touchdown in Taxes*, 7 GONZAGA L. REV. 297 (1972). (2) Relief would be granted to students working their way through school, eliminating the unjustifiable contrast under present law between the tax-free status of a scholarship student and the taxable status of a student with exactly the same standard of living and tuition charges but who has to work in order to meet his expenses. (3) The existing confusion about how to tell a scholarship award from compensation for services in the cases of graduate students, interns, and others in the intermediate zone between student and professional status would be eliminated.

127. Professor Klein has made this point clearly in relation to travel with both business and vacation overtones. Klein, *supra* note 29, at 1111-12.

128. In particular, this reasoning provides support for proposals such as those submitted by the Administration to Congress in 1961. *See President's Recommendations on Tax Revision, Hearings on the Tax Recommendations of the President Before the House Comm. on Ways and Means*, 87th Cong., 1st Sess. 12-13, 281-86 (1961).

129. *See, e.g.*, B. BITTKER & L. STONE, FEDERAL INCOME, ESTATE AND GIFT TAXATION 208 (4th ed. 1972).

130. *See* note 116 *supra*.

131. CODE § 214.

132. *See, e.g.*, Hjorth, *A Tax Subsidy for Child Care: Sec. 210 of the Revenue Act of 1971*, 50 TAXES 133, 138-39 (1972).

133. **See, pp. 2186, *supra*.**

134. This is not to say, of course, that deferral is not important. Deferral may ripen into exclusion, whole or partial, for any number of reasons. And even if it does not, deferral itself reduces the real, present, discounted value of the burden of the tax. *See* W. ANDREWS, FEDERAL INCOME TAXATION: CASES, PROBLEMS AND NOTES 149-54 (1969).

135. See M. DAVID, *supra* note 119, at 93-103.

136 See, e.g., N. KALDOR, AN EXPENDITURE TAX (1955).

137. In the long run an immediate deduction for accumulation expenditures would simplify tax accounting since it would make it unnecessary to preserve cost basis information for use in computing gain or loss on the subsequent sale or liquidation of investment assets.

138. See pp. 2202 *supra.*

139. See pp. 2202-03 *supra.*

140. See pp. 2198-2200 *supra.*

EXPLANATION AND ANALYSIS OF SPLIT-INTEREST GIFTS TO CHARITY

Theodore A. Kurz[†] and Barbara P. Robinson[†]

Introduction

The Internal Revenue Code has long permitted and encouraged gifts of partial interests in property to charity by the allowance of tax deductions for certain forms of qualifying gifts. In all types of split-interest charitable giving, a donor retains for himself, or creates for the benefit of his family or friends, partial interests in the property which will also benefit charity. One underlying reason for permitting a donor to retain or create these noncharitable interests in property, while at the same time allowing him tax deductions for the gift to charity of partial interests in the same property, is to encourage private giving to charitable organizations by donors who are charitably inclined but who cannot afford to part completely with substantial assets.

In general, split-interest gifts to charity involve either a current noncharitable interest followed by an ultimate charitable receipt of the same assets or a current charitable interest followed by an ultimate return of the same assets to private or noncharitable ownership. In the most common forms of split-interest charitable gifts, charity is given a remainder interest in property, with actual charitable ownership or use deferred until the intervening noncharitable interest has terminated. The intervening noncharitable interest may vary in duration and form: it might last for one or more lives or for a fixed period of years; and it might consist of the right to use residential real estate, the right to income from a special fund, or the right to an annual annuity or other payment measured by a percentage of assets. Through such deferred giving, donors are encouraged by the allowance of current tax deductions to make binding future commitments of assets for charitable purposes while retaining for a period of time a personal interest in the same assets. Charity may thus plan for the future with an eye to the committed gift while the donor continues to have the same assets provide for himself and his family.

Since the entire concept of split-interest charitable giving is premised on allowing the retention of personal or noncharitable economic benefit in property irrevocably promised to charity, a delicate balance is necessary to insure that the noncharitable interest is not unduly benefited at the expense of charity. There has been concern that the tax and economic benefits allowed to the donor and his noncharitable beneficiaries may more than outweigh the benefit to charity. From time to time, the Internal Revenue Code has been amended to try to insure that charity will receive the full value of the property originally promised and for which favorable tax treatment was allowed.

With passage of the Tax Reform Act of 1969, the entire area of split-interest charitable giving was dramatically changed. The Internal Revenue Code was amended in an attempt to insure that the amounts allowed as a deduction for the charitable interest bore a reasonable correlation to the value of the benefit actually received by charity. The major innovation was to define specifically the intervening charitable or noncharitable interest as a fixed amount or percentage which could not be increased or altered in any way. The basic approach was negative: it was to disallow any tax deductions unless a split-interest charitable gift was made in one or more of the qualifying forms prescribed in the Tax Reform Act.

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For a donor to make a split-interest gift that will qualify for favorable tax treatment, he must make a gift in accordance with one or more of the provisions of the Code defining and regulating the various types of split-interest gifts. It is the purpose of this report to describe the traditional methods of making and valuing split-interest gifts to charity and to explain and analyze the specific changes made by the 1969 Tax Reform Act that now govern the manner in which such gifts are currently being made, valued, and deducted.[1] In explaining and analyzing split-interest gifts to charity, this report will also examine various issues that bear consideration in connection with split-interest charitable giving.

I

CHARITABLE REMAINDER TRUSTS IN GENERAL

Before the Tax Reform Act of 1969, a donor was permitted to create a charitable remainder trust which paid all the net income to the donor, or his family or friends, with the remainder to charity. The donor was allowed a tax deduction for the value of the charitable remainder interest in such a trust even though principal could be invaded for noncharitable beneficiaries under certain ascertainable standards and even though the charity's interest might be defeated by a remote contingency.

In practice, there were many potential inequities in the use of these trusts. For example, the trustee might invest the trust fund in high-yield securities to benefit the noncharitable income beneficiaries to the detriment of the charitable remainderman; or, as the result of invasions of the trust, charity might receive substantially less than the amount in respect of which the donor was given a current tax deduction. In addition, the tables used to compute the amount of the allowable tax deduction were based on the assumption that the trust fund would earn interest at the rate of 3.5 percent per year, despite the actual yield resulting from the trustee's investments or changes in the prevailing interest rates in the economy. Therefore, the amount of allowable tax deduction did not necessarily bear any relation to the value or benefit that charity ultimately received on the termination of such a trust.

In order more closely to correlate the amount of the tax deduction allowable to the donor with the actual amount received by charity, the 1969 Tax Reform Act provided that no tax deductions would be allowed for gifts of remainder interests in trust unless the trust was in the form of either a charitable remainder unitrust or a charitable remainder annuity trust.[2] These new creatures of the Tax Reform Act were designed to require a specified annual payout (either a fixed dollar amount or a stated percentage of the annual value of the assets) to the "income" beneficiaries. The aim was to remove the incentive to manipulate trust investments to benefit the noncharitable beneficiary at the expense of the charitable remainderman, and this was accomplished by making it irrelevent whether the payout was made from trust income or principal.[3] With the requirement of a specified annual payout to the noncharitable interest, it was believed that the trustee would view the trust as a single fund without distinction between income or principal, so that all investment decisions would be made to favor the trust fund as a whole, rather than the income, as opposed to the remainder, interest. In addition, no invasion of principal in excess of the annual specified payout would be permitted for the benefit of any noncharitable beneficiary, nor would any contingencies be permitted which might prevent the ultimate passage of the property to charity.

The applicable provisions of the Code now mandate that both annuity trusts and unitrusts require a specified minimum distribution at least annually to one or more beneficiaries, at least one of which is not a charity.[4] Annuity trusts must distribute a fixed sum certain, equal to at least 5 percent of the initial value of the trust fund, and unitrusts must distribute a stated percentage of not less than 5 percent of the value of the trust fund, determined annually. Although the Code allows a portion of this minimum annual distribution to be paid to charity, neither the donor nor the trust will be allowed any tax deductions for any such charitable income interests.[5] Since there is no tax incentive to provide that a portion of the specified payout be distributed to charity, it is unlikely that such gifts will be made and, accordingly, the specified minimum distributions are sometimes referred to as "noncharitable," which is accurate as a practical, rather than legal, description. The specified distributions are also sometimes referred to as annuity or unitrust amounts.

In both annuity trusts and unitrusts, the remainder interest must be solely and irrevocably held for the benefit of, or paid over to, charity; and there may be no invasion of the trust fund for any noncharitable beneficiary. The remainder may go to either a "public charity" (a charity described in section 170(b)(1)(A) other than (vii) and (viii)) or to a "private foundation" (a charity defined in section 509), unlike certain other forms of split-interest charitable giving which may only be utilized for the benefit of public charities.[6]

All charitable remainder trusts may continue for a term measured by the lives of one or more beneficiaries in being, or for a term of years of not more than 20, and they must function exclusively as charitable remainder trusts from the date of their creation throughout the trust term.[7] Charitable remainder trusts may be created for the benefit of persons not yet in being whenever the trust term is for a period of years of not more than 20. However, where the trust term is measured by one or more lives, the individual beneficiaries must all be living at the time of the creation of the trust.[8]

Charitable remainder trusts qualifying under the Code will be tax-exempt entities. This will be true except where a charitable remainder trust has "unrelated business income," which includes certain types of "debt-financed property."[9] During any year or years when a charitable remainder trust has unrelated business income, it will be fully taxable on all its income under the usual rules applicable to ordinary trusts.

Distributions from charitable remainder trusts to the noncharitable beneficiary will be taxable to the beneficiary under special characterization rules set forth in the Treasury Regulations.[10] Distributions will first be considered to be ordinary income (to the extent the trust has received ordinary income), second to be net capital gains (to the extent the trust has realized net capital gains), third to be other income (to the extent the trust has received other income), and finally to be corpus. There is an unlimited carry-forward of ordinary income and capital gains to the extent they are considered to be undistributed by the trust in prior years.

The funding of a charitable remainder trust with appreciated property will not result in a capital gain to the donor unless the donor receives property back (other than his income interest) or transfers debt-financed property to the trust.[11] If the trust sells the appreciated property, the capital gain is not taxed to the trust but is credited to the trust's capital gains account. The gain is then deemed distributed to the noncharitable beneficiary on an annual basis in accordance with the above-mentioned distribution rules.

There is no prohibition against the making or retention of any particular investments by charitable remainder trusts. There is only a rather ambiguous statement in the Treasury Regulations which requires the charitable remainder trust instrument to state that nothing shall restrict the trustee from investing the trust assets so as to result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.[12] The meaning of this language is not altogether clear, but it is generally agreed that it was designed to invalidate trust instruments that unduly restrict or limit the trustee's investment discretion and that it was not designed to disqualify charitable remainder trusts in which the trustee is given and exercises full and complete investment discretion. Accordingly, a charitable remainder trust instrument that directs the trustee to invest all the trust assets in tax-exempt bonds may run afoul of this language, but an investment in such bonds under a broad grant of investment authority would not appear to be prohibited by this regulatory provision.[13]

It is possible to distribute assets in kind to satisfy the annuity or unitrust amount. Any trust assets received in kind by the beneficiary will have a basis in his hands equal to fair market value at the time paid and will be treated as a sale made by the trust, with the resulting gain or loss credited to the trust's capital gains account.[14]

The valuation of the remainder interest of a charitable remainder trust for purposes of computing the allowable income, gift, or estate tax deductions will vary with the amount and frequency of the specified annual distribution and the duration of the trust. To value the charitable remainder interest and to compute the allowable tax deduction, it is necessary to use the 6 percent tables provided in 1969 by the Treasury Regulations. The total amount contributed to either type of trust, less the amount computed under the tables as the total value of the intervening noncharitable interest, will determine the size of the deduction, without regard to future fluctuations in the general money market or in the unitrust amount, or the actual investment performance of the trust.

In the creation of an inter vivos charitable remainder trust for someone other than or in addition to the donor's benefit, the donor will be making a gift to the other noncharitable beneficiary. However, the donor may retain a special testamentary power to revoke the interest of such beneficiary[15] and thereby avoid making a completed gift. To the extent such interest remains unrevoked at the donor's death and the trust is includable in the donor's estate, there will be estate tax payable in respect of the value of the interest computed pursuant to the applicable tables.

Charitable Remainder Annuity Trusts

Charitable remainder annuity trusts must pay out a fixed sum certain at least annually to one or more beneficiaries, at least one of which is not a charity. This fixed sum must be established at the creation of the trust and may be either a stated dollar amount or a percentage of the initial value of the trust fund which is at least equal to 5 percent of such initial value.[16] Once this fixed sum is established, it will not fluctuate or change throughout the administration of the trust, regardless of the actual income earned by the trust fund or the subsequent changes in the market value of the fund.

No additional contributions may be made to a charitable remainder annuity trust after its creation.[17] Therefore, annuity trusts will not be useful vehicles for donors who anticipate any additional contributions to the trust fund.

The amount of a transfer to a charitable remainder annuity trust which qualifies for tax deductions will be computed pursuant to the 6 percent tables.[18] The amount of the annuity, adjusted for the timing of the payments, will be multiplied by either the number of years of a trust for a term of years or the appropriate factor for a trust, measured by a life, which will vary with the age and sex of the measuring life. If there is more than one life, special factors will be supplied by the Treasury. Once the discounted present value of the annuity has been thus computed, the value of the charitable remainder will be the fair market value of the initial gift to the trust, less the present value of the annuity.

Charitable Remainder Unitrusts

A charitable remainder unitrust must provide that the trust will distribute a stated percentage of not less than 5 percent of the value of the trust fund, determined annually. This means that, unlike the annuity amount distributable from an annuity trust, the unitrust amount will fluctuate from year to year with the market value of the trust fund. In addition, the donor is permitted to provide as an alternative to such a fixed percentage that the trust will pay out an amount equal to the income actually earned by the trust fund in each year to the extent such income is not more than the unitrust amount for such year. If this income alternative is chosen, the donor is permitted a second option which allows him to provide that, to the extent trust income in any year exceeds the unitrust amount for such year, such excess income shall be paid out to the beneficiary to the extent that the aggregate amounts paid in prior years were less than the aggregate unitrust amounts in such prior years. This was intended to permit flexibility so that it would not be necessary to invade corpus in those years when investments fail to produce an actual yield equal to the unitrust amount.[19]

Since the trustee may incorrectly determine the value of unitrust assets on occasion, the trust instrument must provide for corrective payments to be made. Any excess distributions must be repaid to the trustee by the beneficiaries, and any underpayments must be made to the beneficiaries within a reasonable period. Originally, it had been proposed that no deduction be allowed when there were assets difficult to value, such as closely held stock or possibly real property, unless the value was to be determined by an independent trustee. But no such provision was enacted.[20]

Additional contributions to unitrusts will be permitted but only if the trust instrument contains the required provisions relating to valuation of such additions and resultant changes in the unitrust amount to be paid out.[21]

The value of the charitable remainder of a unitrust and the amount qualifying for a deduction will vary with the specified percentage to be paid out, adjusted by the timing and frequency of the payouts, and the age and sex of the measuring life, or the number of years of the trust term. The fair market value of the gift to the unitrust multiplied by the appropriate factor supplied by the tables will equal the value of the deductible remainder interest.[22]

II

CHARITABLE GIFT ANNUITIES

The gift annuity consists of a transfer of either property or money to a charity in exchange for the charity's promise to pay the donor, or another noncharitable beneficiary, a fixed amount per year for a set term of years or for a term measured by one or more lives. These payments may either begin immediately or be deferred until the annuitant reaches a certain age ("deferred payment annuity").

A donor may transfer cash to a charity in exchange for its promise to pay a fixed annual amount or "annuity" beginning immediately, for the annuitant's life or for a fixed term of years ("single life gift"). The amount of the charitable contributions deduction for such a transfer will depend on what is considered to be the donor's "investment in the contract." The "investment in the contract," which is roughly equivalent to the cost of purchasing such an annuity in the commercial annuities market, is computed under the appropriate tables.[23] The total cash contributed, less the investment in the contract, as so computed, will equal the value of the gift qualifying for a charitable deduction.

The income tax consequences to the annuitant arising from the payments to him are governed by the normal annuity rules.[24] The annuitant is permitted to exclude from his gross income a part of each annuity payment determined by an "exclusion ratio," which equals the "investment in the contract" divided by the "expected return" from the annuity. As mentioned, the investment in the contract is equivalent to the cost of purchasing a similar commercial annuity contract. And the "expected return" is essentially an amount equal to the annual annuity payment multiplied by the life expectancy of the annuitant.[25] The exclusion ratio allows the donor, or his designated beneficiary, to recover his "investment" in the annuity contract tax-free, as a return of capital. Only that part of each payment that is in excess c ratable share of this return of capital is included in his gross income.

It is noteworthy that the amount excluded from payments remains the same, whether the annuitant dies prior or subsequent to his actuarial life expectancy. Thus an annuitant who lives beyond his expected term receives a bonus; he has already recovered all the capital that was invested in the annuity contract, yet he continues to exclude from income a part of each annual payment.

A donor may transfer property to a charity for its agreement to pay an annuity to a primary beneficiary for his life and then to a second surviving beneficiary. The payment to the secondary beneficiary can be either for a term of years or for the duration of that person's life.

The basic tax consequences to the donor are precisely the same as with the single life gift, except that the cost of purchasing a multiple life annuity will be higher than the cost of purchasing a single life annuity; and this will result in a reduced charitable contributions deduction.

The creation of an annuity interest in a beneficiary other than the donor will be a taxable gift to that beneficiary unless the donor retains the power to revoke or alter the interest of such beneficiary. If the secondary beneficiary survives the donor-annuitant, the value of the survivor's annuity, if unrevoked, will be includable in the donor's gross estate for estate tax purposes.

If the secondary beneficiary survives the primary beneficiary, the annuity will be taxable as it was to the primary beneficiary, including only that part of each payment as was taxable to the primary beneficiary before his death. The secondary beneficiary will be entitled to take an income tax deduction, ratably over the term of his life expectancy, for that part of the donor's estate tax that is attributable to the value, as of the donor's death, of that part of the survivor's annuity as is not excludable from gross income. Thus, in effect, the secondary beneficiary will take into income a smaller percentage of each payment than did the donor.

Under Revenue Ruling 72-438, a donor can take a current charitable contributions deduction for a deferred payment annuity. Revenue Ruling 72-438 provides tables from which the present cost of any such annuity can be determined. The deduction will equal the value of the property transferred, less the present cost of the annuity to be received, computed under the applicable tables. The use of a deferred payment annuity allows a donor, who might be in a presently high income tax bracket, to obtain a current charitable deduction while deferring receipt of the income from the annuity until a later year when his income is expected to be in a lower income tax bracket. The amount of each annuity payment which is includable in the beneficiary's gross income is determined by the application of the same principles applicable to a currently payable annuity.[26]

When appreciated property is transferred to charity in exchange for an annuity, the donor will realize and recognize taxable gain. Before the enactment of the 1969 Tax Reform Act the treatment of the gain was markedly different.

In 1969 the Treasury and the Ways and Means Committee developed the bargain-sale rules to apply to all charitable gifts in order to prevent a taxpayer from obtaining a greater tax benefit from a bargain sale of property to charity than the taxpayer would have gotten had he contributed the "net gift" outright and sold the remaining portion of the property on the open market.[27]

Prior to 1969 a transfer of appreciated property in exchange for an annuity resulted in a gain to the transferor which was taxable in the year of the exchange.[28] However, the gain subject to tax was considered to be the excess of the present value of the annuity over the transferor's basis in the property exchanged.[29] The transferor would be entitled to a charitable deduction equal to the fair market value of the property, less the present value of the annuity received.

With the enactment of the Tax Reform Act, the bargain-sale rules of section 1011(b) were made applicable to the charitable gift annuity.[30] The bargain-sale provisions generally operate to increase the taxable gain that will be realized when appreciated property is transferred for an annuity. Before 1969 the entire basis of the property transferred was applied to the annuity in determining the amount of gain to be taxed on the exchange. The bargain-sale rules, however, require the allocation of the basis of the transferred property between the portion of the transfer that constitutes a "sale" of the property for the annuity and the portion of the transfer that constitutes the deductible gift to charity.[31]

The effect of the bargain-sale provisions upon transfers of appreciated property for annuities is qualified by the fact that these provisions apply only if the donor is entitled to a charitable deduction for some part of the transfer. Thus, if the donor exhausts his allowable charitable contributions deduction for the year with gifts in addition to the transfer of property for the annuity then the bargain-sale provisions will not apply to the transfer, unless the transfer gives rise to a "contribution carryover" under section 170(b) or (d).[32]

The operation of the bargain-sale provisions to increase the taxable gain on a given transfer of appreciated property is mitigated somewhat by the provision in the regulations for deferred reporting of the gain realized. Prior to the Tax Reform Act, any taxable gain arising out of the transfer of appreciated property for an annuity had to be reported in the year of transfer. Thus, the limited sanction in the current regulations for deferred reporting represents a break with pre-1969 rules.

There are two conditions for deferred reporting of gain:[33]

1. The annuity is nonassignable or assignable "only to the charitable organization to which the property is sold or exchanged"; and

2. The transferor is the only annuitant or "the transferor and a designated survivor annuitant or annuitants are the only annuitants."

Once the amount of the taxable gain on the transfer is computed under the applicable rules, the gain may be reported ratably over the expected life of the transferor-annuitant (determined as of the age when annuity payments are first to be received by him). Only that portion of the annuity payments that is excluded from the annuitant's gross income as recovery of his "investment" is treated as including the realized gain. Thus for as long as the annuitant is required to report gain, a portion of each annuity payment will constitute ordinary income to him, a portion will constitute gain, and a portion of the payment will constitute tax-free recovery of the investment in the annuity.[34]

It is noteworthy that the regulations explicitly state that even if there is a survivor annuitant, the gain is to be reported over the life expectancy of the transferor-annuitant. If the transferor-annuitant dies later than his actuarial life expectancy, the taxable gain will already have been fully reported by him. If, however, he dies prior to his actuarial life expectancy, the remaining gain may go unreported and untaxed. The regulations specify that such remaining gain will not have to be reported by any person where there is no surviving annuitant.[35] Where there is a surviving annuitant, the gain remaining unreported must be reported ratably by the surviving annuitant or annuitants as part of annuity payments received.

The same regulation provides that where the transferor relinquishes the annuity to the charitable organization to which he transferred the property involved, the gain unreported at that time also will not have to be reported by any person. This provision encourages a transferor, who finds that his later income is sufficient to support him, to benefit charity by relinquishing his annuity without hardship.

Where property is transferred in exchange for an annuity, the charity's obligation to make payments under the annuity could conceivably represent "acquisition indebtedness" which would cause part of the income from that property to be taxed to the charity as "unrelated business income."

The *Clay Brown* provisions[36] relating to acquisition indebtedness in the context of unrelated business income were urged by the Treasury and contained in both the House and Senate bills and ultimately included in the 1969 act, to discourage tax-exempt organizations from acquiring income-producing businesses and/or property with borrowed money.

Congress was generally concerned that tax-exempt organizations not utilize their exempt status to enter into unfair competition with taxable businesses. An obligation to make payments under an annuity contract was, in form, "acquisition indebtedness," whose existence would, under the *Clay Brown* reforms, cause the charitable donee to be taxed on some or all of the income produced by the property thereby acquired. Since the ordinary gift annuity was thought unrelated to the *Clay Brown* situation, the House bill contained an exception to "acquisition indebtedness" for annuities that satisfied certain conditions. Presumably, satisfaction of these conditions was felt to make the annuity unlikely to raise the problems that the *Clay Brown* reforms were intended to solve.[37]

The Code was thus amended to provide that an annuity will not give rise to "acquisition indebtedness" when

1. The annuity is, with a narrow exception, the sole consideration issued in exchange for the property, and the value of the annuity was at the time of the exchange less than 90 percent of the value of the property received by the organization in the exchange;

2. The annuity is payable over the life of one individual, or over the lives of two individuals, in being at the time the annuity is issued; *and*

3. The annuity contract neither guarantees minimum payments nor specifies maximum payments and does not provide for adjustments of the annuity payments with reference to income received from the transferred property or from any other property.[38]

III

POOLED INCOME FUNDS

A donor may contribute property to a so-called "pooled income fund," receive a present charitable tax deduction for the gift, and retain or create a pro rata income interest in the fund for the lives of one or more designated noncharitable beneficiaries. Upon termination of the noncharitable income interest, the then value of the amount contributed to the fund is withdrawn and given outright to the charity. Qualifying pooled income funds may only be maintained by a public charity (a charity qualifying under section 170(b)(1)(A) other than (vii) or (viii)). The public charity need not be the trustee of its pooled income fund but must control the management of the fund. No donor or participant may be a trustee of a pooled income fund.[39]

All gifts to a pooled income fund must be commingled and all transfers and gifts to the fund must qualify under the Code provisions applicable to pooled income funds. A charity may maintain more than one pooled income fund, provided it does not do so in a way to permit manipulation of investments by certain donors.[40] The assets of pooled income funds may also be commingled with other assets of the charity, such as the charity's general endowment fund, or may be invested in an appropriate common trust fund maintained by a bank, provided bookkeeping practices accurately segregate the pooled income interests.

All the income beneficiaries of a pooled income fund must receive their proportionate share of the actual income earned by the fund in each year. The amount paid out to noncharitable income interests by a pooled income fund will therefore fluctuate with the investment performance of the underlying assets of the fund. This is contrary to the provisions governing other forms of charitable split-interest gifts where the payments must be in a fixed amount or percentage of the fund. Since the pooled income fund must be managed by the public charity having the remainder interest and must be open to more than one donor, it has apparently been presumed that the public charity will not manipulate investments in a way to benefit unduly the noncharitable interests. Despite this presumption, pooled income funds are prohibited from investing in tax-exempt securities.[41]

A pooled income fund will be taxed as an ordinary trust but will continue to be allowed an unlimited set-aside deduction for undistributed long-term capital gains retained by the fund. Distributions of income by the fund to its participants are deductible by the fund and taxable to the participants. The fund itself is not a tax-exempt entity as are charitable remainder trusts.

No gain will be recognized by the donor on the transfer of appreciated property to a pooled income fund, unless the donor receives property back (other than his income interest) or transfers debt-financed property to the fund.[42] If the fund sells the appreciated property, the capital gain may be offset by the fund's set-aside deduction for undistributed long-term capital gains.

Since the income interest is not a fixed amount, as in the other forms of split-interest charitable gifts, the value of the charitable remainder qualifying for a tax deduction will be determined on the basis of the actual rate of return earned by the fund. The highest rate of return earned by the fund in any of the three taxable years preceding the gift will be used for this purpose. For newer funds which have not been operating for three years or more, the rate of return will be deemed to be 6 percent, subject to changes made from time to time by the Secretary of the Treasury.

Special tables provided in the Treasury Regulations provide the relevant factors, based on the highest rate of return earned by the pooled income fund in the three years prior to the gift, or 6 percent, for purposes of computing the value of the charitable remainder interest. The net fair market value of a gift to a pooled income fund would be multiplied by the appropriate factor supplied by the tables, which vary with the age and sex of the income beneficiary, to give the present value of the charitable remainder interest qualifying for a tax deduction.[43]

As in the case of charitable remainder trusts, the creation of one or more secondary income interests in a pooled income fund will be a taxable gift by the donor unless he retains a special testamentary power to revoke such income interests.

IV

CHARITABLE LEAD TRUSTS

A gift to charity of an income interest with a remainder or reversion of the assets for noncharitable purposes will only qualify for a tax deduction if the gift is in the form of what has been called a "charitable lead trust." A charitable lead trust requires that the annual amount payable to charity be either in the form of a guaranteed annuity or a unitrust amount.[44] For estate and gift tax purposes, a trust is not required provided certain standards are met to insure a guaranteed annuity interest or unitrust interest.[45] No amounts may be payable to noncharities, except from segregated assets, but income in excess of the annuity or unitrust amount may be paid out to the charity.[46] The term of the trust may be for the life or lives of named individuals or for a term of years with no limitation on the length of the term. The charitable lead trust is the converse of the charitable remainder trust in that the annuity or unitrust amount in the lead trust is payable to charity, with the remainder payable to noncharitable beneficiaries. Unlike the charitable remainder trust, there is no minimum amount that must be paid out annually, so that the annuity or unitrust amount payable to charity may be less than 5 percent of the trust fund.

Before the passage of the Tax Reform Act, it was possible for a donor to create a two-year trust with the income to go to charity and the trust fund to revert to the donor after the two-year term. During the two years, the donor excluded all the trust income from his gross income, thereby avoiding the maximum 30 percent charitable deduction then allowed. A donor could also create a charitable income trust with a noncharitable remainder, deduct the value of the charitable income interest, and, as in the case of the two-year reversionary trust, exclude all the trust income from his gross income. This led to the 1969 repeal of the two-year charitable trust and the denial of an income tax deduction unless the donor remained taxable on the trust income.[47]

Thus, under the 1969 Tax Reform Act, a donor is permitted an *income* tax deduction for a charitable lead trust only if he remains fully taxable on trust income. In addition, the charitable income interest must be in the form of an annuity or unitrust interest to insure that the amount received by charity bears a reasonable correlation to the amount allowed as a deduction.

If the donor is so taxable on all the trust income, he will receive an income tax deduction in the year he creates the charitable lead trust based on the value of the charity's interest as computed pursuant to the applicable tables; neither he nor the trust will receive any further charitable contributions deductions for the annuity or unitrust amount paid to charity annually.[48]

If at any time before the end of the charitable term the donor should cease to be taxable on the trust income as earned, there is a recapture provision which provides, in effect, that the donor shall be deemed to have received taxable income equal to the amount of the income tax deduction originally allowed, less the discounted value of all amounts actually paid out to charity before the donor ceased to be taxable.[49] In the examples given in the Treasury Regulations, the donor's death will also trigger this recapture provision, although this does not seem appropriate in light of the legislative history.

In the event the recapture provision is triggered, the trust is allowed deductions for subsequent amounts actually paid out to charity, and the donor is entitled to deduct amounts paid to charity in excess of the annuity or unitrust amount.[50]

Because of this income tax treatment, the use of inter vivos charitable lead trusts is likely to be quite limited. Testamentary charitable lead trusts, or their equivalent in non-trust form, may be used more extensively to permit the testator's estate to receive a charitable estate tax deduction for the bequest of the income interest, to relieve the testator's family from realizing and paying tax on such income during the term of the trust (possibly during their high tax bracket years), and ultimately to have the trust remainder pass to members of the testator's family.

To the extent the trust fund appreciates substantially during the term of the trust, the testator's noncharitable remaindermen will eventually receive these appreciated assets after an estate tax saving.

Because the rules for gift and estate tax deductions do not require that the donor remain taxable on charitable lead trust income, a donor may still create a charitable lead trust that does not qualify for a charitable income tax deduction but does qualify for estate and gift tax deductions.

The valuation of a charitable lead trust for purposes of tax deductions is computed under the same tables applicable to charitable remainder unitrusts and annuity trusts, the difference being that the fair market value of the income interest, rather than the remainder interest, will be the deductible amount.[51] However, in certain cases where it appears that the charity may not receive the full value of its income interest, as, for example, where the fair market value of the property is less than the value of the income interest computed pursuant to the appropriate tables, the charitable deduction will be limited to the minimum amount that charity will receive. In most cases, this will mean that the deduction will be limited to not more than the initial fair market value of the trust fund.

Charitable lead trusts are taxable as ordinary trusts, and any amounts not paid out to charity are taxable to the trust.

There is no prohibition against charitable lead trusts investing in tax-exempt securities. It is therefore possible for a donor to fund such a trust with tax-exempts or cash which may be used to purchase tax-exempts, qualify for a present income tax deduction, and satisfy the requirement that he remain taxable on subsequent trust income without actually paying tax on that income.

Where the charitable interest exceeds 60 percent of the initial value of a charitable annuity lead trust fund, the trust instrument must include a provision that section 4944, prohibiting jeopardy investments, will apply to such trust.[52] This is a compromise solution to the initial Treasury proposal that no deduction be allowed where the charitable income interest exceeded 60 percent. It was feared that the donor of such a trust would receive a tax deduction equal to 100 percent of the initial value of such a trust fund, since the remainder would be considered to have no present value under the applicable tables. The donor would thereby be encouraged to "gamble" with the investments of such a trust fund, investing in highly speculative securities in the hope of favoring the remaindermen.[53] If such speculative investments resulted in loss, the donor would have received a full tax deduction and therefore have very little real loss. Section 4944 was made applicable to such annuity trusts, including the imposition of personal liability on the trustee, in an attempt to discourage such an investment approach.

V

REMAINDER INTERESTS IN PERSONAL RESIDENCES OR FARMS

A donor may retain a life estate or an estate for a term of years in a personal residence or farm and be allowed a charitable deduction for a gift of the remainder interest to charity.[54] A "personal residence" includes any property used by the taxpayer as his personal residence, even though it is not his principal residence. Thus a summer home qualifies, as does stock owned by a taxpayer as a tenant-stockholder in cooperative housing if used as a personal residence. A "farm" is defined by the regulations as any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock (which includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry), and any improvements thereon.[55] As with all other interests qualifying for a charitable deduction, the charitable remainder may not be contingent or conditional.

The value of a remainder interest in a residence or farm will be computed under the applicable tables.[56] Depreciation computed on the straight-line method and cost depletion must be taken into account, and the value discounted at a 6 percent rate. In the case of a combination of both depreciable and nondepreciable real property, the fair market value must be allocated between the depreciable and nondepreciable portions, and the expected value of the depreciable property at the end of its "estimated useful life" must be calculated and treated as nondepreciable property.

The regulations provide tables for the valuation of a remainder interest in real property following one life or a term of years. The IRS will provide special factors in the case where there is an actual gift either measured by more than one life or requiring a depletion allowance reduction.

The chief "abuse" that the Tax Reform Act attempted to eliminate in the context of split-interest gifts of real property was the practice of giving charity the rent-free use of such property. Such a gift enabled the donor to take a "double deduction" in that the rental value of the property was deductible, and the taxpayer could exclude from income the rental he would otherwise have received from the space used by the charity. The Treasury therefore proposed that no deduction be allowed for the contribution of the right to use property. Spokesmen for various charitable institutions–chiefly private colleges and universities–objected to this elimination on the grounds that a favored vehicle for charitable donations was the gift of a remainder interest in real property, such as a farm or residence. The Senate Finance Committee, while acknowledging that gifts of remainder interests in real property did not generally present the kind of abuse the House bill sought to curtail, noted that this form of gift did present a "limited valuation problem."[57] The solution was to require donors to take depletion and depreciation into account and to apply a 6 percent rate of return in valuing such gifts.

The bill as reported from the Senate-House Conference incorporated the Senate amendments, except that the Senate exception for remainder interests in real property was limited to remainder interests in personal residences or farms, and in taking depletion or depreciation into account in valuing interests in real property, the straight-line method of depreciation or cost depletion method was to be employed.

Neither the Code provisions nor the regulations require that straight-line depreciation and/or cost depletion be taken into account in calculating the value of an estate or gift tax deduction for the transfer of a remainder interest in real property. This appears to be an anomaly as there is nothing in the Senate or Conference Committee Reports that indicates that these factors were to be included only in the calculation of the income tax deduction.

VI

AN UNDIVIDED PORTION OF THE DONOR'S ENTIRE INTEREST IN PROPERTY

A deduction is allowed for the contribution of an undivided portion of the donor's entire interest in property,[58] so long as this interest constitutes "a fraction or percentage of each and every substantial interest or right owned by the donor in such property" and extends "over the entire term of the donor's interest in such property and in other property into which such property is converted."[59] In other words, the donor must give a part of everything he has, for as long as he has it. The donor cannot transfer some specific rights and retain others. Examples in the regulations of gifts qualifying for a deduction under this provision include:

- a one-half interest in a life estate in an office building;
- a 20 percent interest in a remainder interest created by a testamentary trust;
- an interest in property held as a tenancy in common with the donor, if the charitable recipient has the right to possession and control of the property for a portion of each year appropriate to its interest in the property; and

- an open space easement in gross in perpetuity—this is defined by the regulations as a personal interest in, or right to use, the land of another. The easement is not supported by a dominant estate, but is attached to, and vested in, the person to whom it is granted.

The present value of an undivided portion of the donor's entire interest in property, if measured by a life or lives or by a term of years, is determined by using the applicable actuarial tables.[60] The fair market value of a contribution of an open space easement in perpetuity, however, may be determined by a different method. Since it is difficult to determine the market value of an easement, there being no established market for such interests, the Treasury will allow an easement to be valued on the basis of a "before and after" approach. A deduction will be allowed in an amount equal to the difference between the value of the property before the grant of the easement less the value of the property thereafter, encumbered by the grant.[61] Further, the basis of the property must be adjusted by eliminating that part of the total basis that is properly allocable to the restrictive easement granted.[62]

Section 170(f)(3) of the Code dissuades a donor from divesting himself of an interest in property that he does not desire to give to charity and then claiming a deduction for the remaining interest as his "entire" interest, or for a qualifying portion thereof. The income tax regulations disallow a deduction for a gift under such circumstances if "the property in which such partial interest exists was divided in order to create such interest and thus avoid Section 170(f)(3)(A) . . . ."[63] The estate and gift tax provisions will disallow the deduction if at any time prior to the charitable transfer, an interest in the property had passed from, or been transferred by, the donor to a noncharitable recipient.

VII

CHARITABLE GIFTS OF LIFE INSURANCE

A donor has historically been able to take an income tax deduction for a gift of a life insurance policy to a charitable organization, or for the payment of premiums on a life insurance policy if a charitable organization either owns the policy or is named irrevocable beneficiary and the insured does not retain the right to surrender the policy for cash.[64]

Prior to the Tax Reform Act, the donor was entitled to deduct the full fair market value of his contribution. Now, the amount of any charitable contribution must be reduced by the amount of gain that would have represented ordinary income to the donor had he sold the property at its fair market value.[65] Since gain realized from the sale of a life insurance policy is taxed as ordinary income, a deduction for a charitable gift of a life insurance policy is restricted to the donor's cost basis in the policy when the value of the policy exceeds his basis.[66]

The Tax Reform Act changed the treatment of "bargain sales" of property to charitable organizations, and the new treatment is fully applicable to such sales of insurance policies. As a result of the Tax Reform Act, the donor must now allocate his basis between the portion of the policy sold and the portion for which no consideration was received.[67] Since the sale of an insurance policy by an individual may generate ordinary income, the inducement to sell a policy to a charitable organization at a bargain price has been reduced even further than in the case of a bargain sale of a capital asset.

In two revenue rulings published before the Tax Reform Act, the Internal Revenue Service approved charitable deductions for certain "split-dollar" insurance plans which permitted a donor to allocate the benefits between private and charitable beneficiaries. In Revenue Ruling 69-79, 1969-1 *C.B.* 63, an individual irrevocably assigned the cash surrender value of a paid-up insurance policy on his life to a qualified charitable organization. He reserved the right to designate noncharitable beneficiaries for the face amount of the policy (subject to the charity's right to the cash surrender value). Thus upon his death, the charity was entitled to the cash surrender value, and the noncharitable beneficiary was entitled to the face amount of the policy less the cash surrender value. The charity was also given the right to surrender the policy for its cash value, thereby canceling the policy, or to borrow from the insurance company against the cash surrender value. The individual was held to be entitled to a current charitable contributions deduction equal to the cash surrender value of the policy.

Revenue Ruling 69-215 1969-1 *C.B.* 63 involved a similar split-dollar gift of life insurance to a charity, but premiums remained to be paid on the policy and the charity could not receive its cash surrender value until either the death of the insured or a default on payment of the premiums. The Internal Revenue Service ruled that the donor was entitled to a charitable contributions deduction for the present cash surrender value of the policy and the increase in the present value of the charity's interest when an annual premium was paid.

It is presently unclear whether such split-dollar insurance plans continue to be effective in providing charitable contributions deductions. The 1969 enactment of section 170(f)(3) of the Code disallows a deduction for a non-trust contribution of less than a donor's entire interest in property unless in one of the qualifying forms. It seems unlikely that the split-dollar plans approved in the above rulings can be brought within any of these limited exceptions to the general rule of section 170(f)(3).[68]

VIII

VALUATION OF SPLIT-INTEREST GIFTS TO CHARITY

In the typical split-interest gift, the donor makes an irrevocable commitment to charity but retains for himself some continuing interest in the income or in the use of the property.[69] This kind of giving is often attractive to those who desire a present tax deduction for their philanthropy but who are not of the means or of the disposition to divest themselves of the benefits that they presently enjoy. Since charity will not actually receive the gift until the donor's retained interest has terminated, some kind of fair division must be made between the charitable (deduction) and the noncharitable portions. It is important that the size of the deduction reflect that the charitable gift will not be available to the charity for charitable uses until the noncharitable interest has terminated. As a result, the future value of the charitable portion of the gift must be discounted to reflect its current value.

Although interest rates vary over time, practical limitations in making computations require that certain simplifying assumptions[70] be made. The first and most important assumption is that the effects of inflation are not considered (as they are also not considered elsewhere in the federal tax system, for example, in the treatment of capital gains or inventories). So, too, once an interest rate[71] has been chosen for discounting purposes, that rate is applied without variation over time[72] and on the assumption of continuous compounding. For many years the rate of return used to value split-interest gifts (and for many other purposes) was 3.5 percent. While at one time this was a reasonable reflection of interest rates in the money market for long-term commitments, it was thought by some to be too low by 1969. After that year the rate was changed upwards to 6 percent. But now with the combination of a severe economic recession accompanied by record-high interest rates, it appears appropriate to examine the rate once again.[73] The potential need for another change in the interest rate used in the tables after only five years shows that it might be desirable to provide for some kind of periodic and systematic reconsideration and possible recalculation of the valuation tables based on changed money market conditions and real rates of return on model portfolios. To accomplish this, it might be desirable to institute some procedure comparable to section 4942(e)(3), which is a statutory command to the Treasury Department to periodically recalculate the mandatory payout rate applied to private foundations. As explained in the next section, such a change will have a mixed impact on the size of charitable deductions for split-interest giving.

The Effects of Revising the Six Percent Tables

A recalculation of all the valuation tables changing the assumed rate of return from 6 percent to some higher rate, say 9 percent, would decrease the value of the charitable interest in split-interest gifts of real property, both depreciable and nondepreciable, and of certain pooled income funds. Conversely, such a revaluation would increase the value of charitable deductions for both charitable remainder annuity trusts and unitrusts.[74]

For split-interest gifts of real estate and for pooled income funds in existence for less than three taxable years, the result of such a revaluation would be to reduce the value of the charitable deduction.[75] In both of these cases it is assumed that the annual economic return to the noncharitable recipient is equal to the increased rate of return times the value of the asset or assets. Since this assumes that all of the income generated by the gift is distributed to the noncharitable beneficiary, the size of the gift at the time it eventually passes to the charity is not altered in any way by changing the rate of return. Raising the rate does, however, have the effect of discounting the net present value of the future charitable transfer by an increased amount, and the current value of the future charitable gift is accordingly reduced.

In the case of a charitable remainder annuity trust,[76] the actual noncharitable fixed dollar payout does not vary by changing the assumed rate of return (for example, from 6 percent to 9 percent). As a result, the effect of increasing the assumed rate of return above the rate of the annual noncharitable fixed payout is to increase the charitable portion of the gift.[77] In the charitable remainder unitrust, the same effect is seen although its impact is diluted. As the unitrust payout is based on a fixed percentage of the annual value of the trust, the annual payout will increase as the value of the trust rises. The fact that the percentage of the payout is fixed, however, means that a change in the assumed rate of return from 6 percent to 9 percent will not be matched by a change in the payout percentage (as would be the case, for example, in valuing a life estate in real property). Thus, while unitrust payouts to noncharitable beneficiaries would be slowly rising over time, these increases would not fully equal the assumed increase in the earning power of the trust, leaving an enlarged trust corpus for eventual transfer to the charity.

Why Different Types of Split-Interest Gifts of Money Can Produce Different Sized Deductions

As the accompanying table shows, it is possible to get widely varying deductions for a split-interest gift of the same amount of money even when the noncharitable payout is set at the same percentage (in this example 5 percent, which is the statutory minimum for charitable remainder trusts).

Several explanations and limitations on the table must be stated. The assumed noncharitable discount rate for a life estate in a farm or residence (rental value) is 6 percent, not the 5 percent at which the other categories are set. The discount rate applied to pooled income funds is not 6 percent, but 5 percent which, by assumption in this example, is the historic rate of return for the particular pooled income fund involved.

Although differing sized charitable deductions are allowable for equal gifts to a charitable remainder annuity trust versus a unitrust, the difference seems to be supportable. In general, a contribution to an annuity trust with a payout rate lower than the discount rate will qualify for a larger deduction than the same contribution to a unitrust (assuming the same payout rate), and the deduction will be smaller when the annuity trust payout rate is higher than the discount rate.

In the unitrust situation, as explained previously, the amount of the payout fluctuates, increasing and decreasing with the size of the trust, while the amount of the annuity trust payout remains constant. Assuming a payout rate less than the discount rate, the fund is presumed to have some net income at the end of every year in excess of its payout requirements. This net income serves to increase the size of the fund. This will increase the size of the unitrust payouts in later years but not the size of the annuity payout. Accordingly, under these circumstances, an annuity trust will give a larger deduction than a unitrust. If, however, one were to assume a payout rate at 7 percent (in excess of the discount rate), one would get a greater deduction by using a unitrust as opposed to an annuity trust since the fixed annuity would continue at the same dollar amount each year even as the size of the trust was declining, while in the unitrust the payouts would be declining over time as the value of the trust declined. The point at which the unitrust deduction is exactly the same size as the annuity trust deduction is where the payout is set roughly equal to the discount rate, which is presently 6 percent.[78]

Although the subtle differences among unitrust, annuity trust, pooled income fund, and life interests in farms or residences have required a multiplicity of differing valuation tables which must all be mastered by the sophisticated tax lawyer, their independent and separate existence is justified and necessary because of the inherent differences among these various methods of split-interest giving.

One area in which valuation of the split-interest gift appears unjustified is in the gift annuity area where the charitable deduction for gifts to charities that grant annuities from time to time is calculated as the difference between the size of the amount of money given to the charity and the cost of purchasing a similar annuity in the commercial annuities market. The tables reflecting the value of such annuities are not simply a combination of a 6 percent discount rate and actuarial assumptions about life expectancies. Instead, they are based on the cost of annuities in the commercial market, where, presumably, a profit margin and perhaps a different discount rate have been used in calculations by the commercial sellers of these annuities.[79] By contrast, the charitable remainder annuity trust tables do not, nor should they, include a profit margin. Yet the assets of a gift annuity go directly to the charity and are subject to the charity's use, ownership, management, and control, while the charity is rarely trustee or in control of a charitable remainder annuity trust. This difference in valuation and size of deduction thus makes little policy sense unless one assumes that charities receiving gift annuities satisfy them by purchasing commercial annuities and, conversely, that trustees of charitable remainder annuity trusts do not purchase commercial annuities. Neither assumption may be fully justified.

IX

ISSUES RELATING TO SPLIT-INTEREST GIFTS TO CHARITY

The Propriety of the Tax Treatment of Split-Interest Gifts to Charity

While tax deductions have traditionally been allowed for split-interest gifts to charity, a basic policy underlying the Tax Reform Act was to encourage present charitable giving and to limit and curtail the types of split-interest gifts qualifying for favorable tax treatment. The Code now disallows deductions for split-interest gifts in general, with the exception of the several types of split-interest gifts previously discussed. It has been maintained, however, that the act only complicated the methods of split-interest giving and did not deal directly with the real policy issue as to the propriety of allowing current tax benefits for future charitable benefits.

One of the underlying objectives of the Tax Reform Act in the charitable area was to favor the present use of funds for charitable activities and to discourage accumulations or deferrals. In the private foundation area, the Code mandated minimum annual payouts to public charity in an attempt to produce immediate benefit to society. If this were deemed to be an overriding policy, the Code could be further amended to disallow tax deductions for any form of split-interest gifts and to allow deductions only for property presently passing to charity.

A certain simplicity would be achieved by disallowing split-interest gifts. There would be no need for complex valuation tables required to compute the present value of property depending upon *when* it would pass to charity in the future, and there would be no uncertainty as to *what*, in fact, would actually be received by charity. If deductions were allowed only for property presently passing to charity, the value of the gift would be evident, subject to the usual problems of valuing certain unique types of property such as real estate and tangibles. Private donors might continue to create split-interest gifts, despite the lack of tax incentives, but in the absence of tax deductions such gifts would pose no particular valuation problems.

In addition, there would be no need for the complex and technical conditions presently imposed by the Code upon qualifying split-interest gifts to guard against manipulation of property in favor of the noncharitable interests. Whenever split-interest gifts to charity are created, there is the inevitable possibility of conflicting interests between the noncharitable and charitable beneficiaries of the same property. If split-interest gifts no longer qualified for favorable tax treatment, there would be no public interest in monitoring the management of any such funds, other than pursuant to the local law of the various states applicable to fiduciaries in general.

The cost of achieving such simplicity by disallowing tax deductions for split-interest gifts would be the risk of decreasing the amount of split-interest gifts passing from private donors for charitable purposes (although this decrease might be offset in part by an increase in current charitable giving by the same charitably minded donors). While there are few reliable statistics in this area, it is noteworthy that many charitable organizations maintain that much of their support comes in the form of deferred giving.

Encouraging any form of charitable giving indirectly through favorable tax deductions has been questioned and challenged over the years. To the extent that tax deductions continue to be used generally as incentives for charitable giving, it seems unnecessary and undesirable to eliminate this incentive in the area of split-interest gifts if the two basic problems of valuation and prevention of abuse can be satisfactorily resolved. It was with these two problems that the Tax Reform Act attempted to deal, as described in the foregoing portions of this paper. It is too early to tell whether these problems have been effectively resolved, but for the time being it would seem unwarranted to conclude that the act will not have the results that were intended.

The Valuation of Split-Interest Gifts to Charity

Six Percent Tables

One of the main thrusts of the 1969 Tax Reform Act was to insure that the amount of the allowable charitable deduction bore a reasonable correlation to the value ultimately passing to charity. In order to determine the charitable deduction allowable for a split-interest gift, it is necessary to consult the applicable tables published by the Treasury. These tables are based upon actuarial concepts regarding average life expectancies and upon a discounting of the future value of the charitable portion of the gift to reflect its current value. The tables arbitrarily assume a 6 percent rate of return during the period that the gift remains split between the charitable and noncharitable interests. While this represents an advance over the 3.5 percent tables used before the 1969 Tax Reform Act, it is questionable how reasonable and realistic these new tables are in the current economy. The following options bear consideration:

1. One approach to the valuation question would be to take a second look when charity has received its full interest and to make appropriate recapture or additional allowance adjustments at that time to reflect the actual value that charity ultimately received. There is presently such a recapture provision in the income tax regulations applicable to charitable lead trusts, and such an approach generally would be one way to insure with certainty that the amount of the deduction allowed would ultimately be justified by the value passing to charity. However, so long as noncharitable beneficiaries other than the donor are involved, such an approach would appear to create undue complexities, complications, and disincentives with respect to split-interest giving.

2. A second approach to the valuation question would be to set a rate of return for a given period of years but to mandate a review and revision (if appropriate) of the rate at the end of each such period. The rate of return, as revised from time to time, could take into account long-term lending rates and real rates of return on model portfolios and would provide a realistic deduction based upon all relevant economic conditions prevailing at the time of the gift. Later revisions of the rate would not affect an earlier deduction based upon an earlier rate. Such an updated valuation system may either increase or decrease the charitable deduction allowable, depending on the nature of the rate revision (up or down) and the type of split-interest gift. However, such a system would make the valuation process much more precise on the basis of the information available at the time the gift is made, without creating substantial additional complexity for the donor or the Internal Revenue Service.

3. A third possible approach would simply be to set an arbitrary rate of return for a long period of time. It would be recognized that the rate was set to benefit the Internal Revenue Service and charity, and that it was both arbitrary as well as imperfect. No periodic review or revision of the rate would be necessary, and there would be no opportunity for undue private benefit. While this approach lacks precision, it may be the simplest and most realistic method to resolve the uncertainties of valuation.

Differences in Valuation for Various Types of Split-Interest Gifts

Consideration of the valuation tables and rules applicable to different kinds of split-interest gifts reveals substantial inconsistencies and widely varying deductions for gifts of equal value. Many of these inconsistencies and varying deductions can be justified and explained by the inherent differences among the various methods of making split-interest gifts. One area in which the differences do not appear justified, however, concerns the valuation of gift annuities to charities which grant annuities from time to time, as opposed to charitable remainder annuity trusts. For practical purposes, these two methods of split-interest giving are very similar and yet the former is valued in relation to the cost of purchasing a similar annuity in the commercial annuities market, while the latter is valued pursuant to the 6 percent tables. In most cases this results in a lower deduction for a gift annuity, presumably because commercial annuity rates reflect a different discount rate as well as a built-in profit margin for the seller of the annuity. Yet the assets of a gift annuity go directly to the charity and are subject to the charity's use, ownership, management, and control, while the charity is rarely trustee or in control of a charitable remainder annuity trust. This difference in valuation and size of deduction thus makes little policy sense unless one assumes that charities receiving gift annuities satisfy them by purchasing commercial annuities and, conversely, that trustees of charitable remainder annuity trusts do not purchase commercial annuities. Neither assumption may be fully justified.

The Annual Five Percent Minimum Noncharitable Payout for Charitable Remainder Trusts

The value of a charitable remainder depends in large part on the amount of the noncharitable annuity or unitrust interest. As the noncharitable interest decreases, the charitable interest (and the charitable deduction) increase. Yet, in creating charitable remainder trusts in 1969 ostensibly to insure charitable benefits, Congress provided that such trusts must have a 5 percent minimum noncharitable payout. Although the Code provides that the 5 percent minimum must be paid to one or more persons, at least one of which is not a charity, no charitable deduction is allowable for any portion of the 5 percent minimum, even if it is directed to be paid to charity. Since there is no incentive to leave any of the 5 percent minimum to charity, it is unlikely that such gifts will be made and, accordingly, the minimum is referred to as "noncharitable" which is accurate as a practical, rather than legal, description.

The legislative history suggests that there was some analogy drawn between charitable remainder trusts and private foundations, both of which were to be tax-exempt entities. Since private foundations were to be required to distribute a minimum amount annually, so too were charitable remainder trusts. This analogy was faulty, however, because private foundations are generally required to pay out to public charities while charitable remainder trusts could be expected to pay out the minimum to private interests. There was also sentiment expressed in 1969 that if charitable remainder trusts had no minimum annual payout, they could be used—as foundations had allegedly been used—as tax-exempt repositories of funds that were being accumulated rather than used for current charitable purposes. Once again, even if this fear was justified, the provision of a noncharitable minimum payout was a totally unsatisfactory resolution because it has the effect of depriving charity of funds it might otherwise receive.

In sum, the noncharitable minimum payout was ill-advised, and consideration should be given to abolishing the minimum so that donors who desire to retain an interest of less than 5 percent can do so and thereby receive an appropriate deduction for the creation of a larger benefit for charity. If there were concern that abolishing the minimum would create a loophole for foundations to become charitable remainder trusts and thereby avoid the current charitable payout applicable to foundations, an alternate solution would be to retain the minimum but to revise the method of computing the charitable deduction to take into account a larger charitable interest if the donor provided for a portion of the 5 percent minimum to be allocated to charity.

Inconsistencies Among Various Types of Split-Interest Gifts

Investment in Tax-Exempt Securities

Congress saw fit in 1969 to prohibit pooled income funds from investing in tax-exempt securities. The policy behind this provision is not altogether clear, although it seems to be related to the sentiment that a deduction for a split-interest gift to charity should not be coupled with an arrangement to shelter (through tax-exempts) the noncharitable interest receivable by the donor. For no explained reason (except, possibly, inadvertence), no prohibition from investing in tax-exempts was applied to other types of split-interest gifts, such as charitable split-interest trusts. Since pooled income funds must be open to the public and may not favor one donor or a group of donors, there would seem to be less incentive to invest in tax-exempts to favor private interests than in the charitable split-interest trusts. To the extent it seems worth prohibiting, the prohibition should apply to both types of entities.

Gift Annuities Versus Charitable Remainder Annuity Trusts

While a variety of types of split-interest gifts are encouraged by the Code, it is interesting to note the inconsistencies in treatment and taxation of the several forms of gifts. For example, a donor who retains an annuity interest in property will be treated differently if he uses a gift annuity or a charitable remainder annuity trust. If the gift annuity is used, he may have to recognize gain on the transfer of appreciated property, whereas no gain is normally recognized on such a transfer to a charitable remainder annuity trust. The income tax treatment of the annuity recipient is also markedly different. A gift annuity is taxed as an ordinary commercial annuity: the annuitant is considered to recover the "cost" of the annuity as a tax-free portion of each annuity payment received annually. The recipient of a charitable remainder annuity trust is taxable on receipt under the special characterization rules applicable to such trusts. As previously mentioned, the computation of the charitable deduction for these two types of gifts is also quite different. Consideration should be given to whether these and other inconsistencies are warranted and should be preserved.

General Thrust and Effect of the 1969 Tax Reform Act on Split-Interest Trusts; The Need for Transitional Relief

The policy of encouraging charitable giving in the form of split-interest gifts is presumably to encourage donors of moderate means to make present binding commitments in favor of charity while receiving significant current tax benefits for themselves or their families. Those who are not of the means or of the disposition to part with substantial assets may thus promise them to charity at a later time and receive a present tax deduction for such a promise. Charity may plan for the future with an eye to the committed gift while the donor continues to have the same assets provide for his own needs during his life or, after his death, for the needs of his family.

Since private interests will be retained in the same property promised to charity, the 1969 Tax Reform Act attempted to insure that the assets would not be unduly manipulated in favor of the private interests at the expense of charity. The thrust of the act as it relates to split-interest giving was twofold: to prevent investment manipulation in favor of the noncharitable interests and to insure that the amount of the current tax deduction allowable for the charitable gift bore a reasonable correlation to the value which charity ultimately received. There were other specific matters at issue in 1969 which have largely been corrected (for example, repeal of the two-year charitable trust, prohibition of deductions for charitable use of rental property, bargain-sale rules, allocation of basis, and treatment of gifts of appreciated property), but these were the two fundamental concerns.

In introducing the concept of fixing the noncharitable amount payable in the form of an annuity or unitrust interest, it was felt that this would encourage a

Deductible Charitable Remainders
($200,000–5 percent annuity or adjusted payout; 6 percent discount rate)

Duration of Income Interest (term certain)	C.R. Fixed Annuity	C.R. Unitrust[a]	Gift Annuity	Life Interest in a Non-Depreciable Part of a Farm or Residence	Pooled Income Fund
5 yr.	$157,876	$154,756	--[b]	$149,452	--[c]
10 yr.	126,390	119,748	--	111,760	--
20 yr.	85,301	71,697	--	62,360	--
Life Interest, Income Beneficiary Aged					
5 m.	$ 40,447	$ 11,532	$ 27,470	$ 8,536	$ 12,924
21 m.	48,256	22,688	33,040	17,908	24,794
55 m.	97,040	84,372	76,550	76,448	87,502
70 m.	131,177	124,292	116,540	117,412	126,912
70 f.	120,766	112,474	104,500	104,920	115,372

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a. All cash payments made in one installment at end of each tax year. Assuming an annual valuation date which is less than one month before the annual distribution date so that there is no necessity of adjusting the payout rate under Table F in Regs. § 1.664-4(b)(5).

b. Data for terms certain not given in Rev. Rul. 72-438, 1972-2 C.B. 38. The discount rate and other factors used therein are not stated so it is impossible to make independent computations.

c. Terms certain not permitted. Section 642(c)(5)(A); Regs. 1.642(c)-5(b)(2).

Sources: For Charitable Remainder Fixed Annuity, Regs. § 20.2031-10(a) et seq.; for Charitable Remainder Unitrust, Regs. § 1.664-4; for Gift Annuity, Rev. Rul. 72-438, 1972-2 C.B. 38; for Life Interest in the non-depreciable part of a farm or personal residence, Int. Rev. Code of 1954 § 170(f)(4), Prop. Reg. § 1.170A-12 (N.B. depreciation was ignored in this example for purposes of more obvious and accurate comparison); for Pooled Income Fund, Regs. § 1.642(c)-6. This table was adapted from Swados, "Charitable Remainder Trusts–Drafting and Valuation Guidelines", 29 N.Y.U. Institute of Federal Taxation 2023, 2048 (1971).

single fund approach to investments and eliminate the incentive to manipulate investments in favor of the noncharitable interests. In addition, it was thought to be a way to separate and value more accurately the income and remainder interests under the applicable tables.

There was a great price paid for this innovation. It was the price of enormous complexity. There are those who firmly believe that the introduction of this complexity has had the effect of inhibiting the creation of split-interest trusts and that the overkill of 1969 has severely offset the policy of the Code to favor and encourage the creation of such trusts. Such critics argue that the fundamental goals of the 1969 act could have been achieved without the counterproductive complexity of the annuity and unitrust concepts. They argue that manipulation of investments could have been prevented by regulating the types of investments and supervising and auditing the fiduciaries to insure that they complied with their fiduciary responsibility to manage the fund impartially and in the best interests of all the beneficiaries. They further argue that the integrity and precision of the tax deduction allowable for split-interest gifts could have been insured by a simple prohibition of any invasions of the fund rather than by the annuity and unitrust concepts. These critics conclude that a simple combination of regulation of fiduciary activity and prohibition of invasions would have obviated the necessity for the fixed payout concept without jeopardizing the incentives to make split-interest gifts in trust.

It is very difficult to ascertain with any certainty whether the 1969 act has had the inhibiting effect that has been attributed to it. It is virtually impossible to know how many more or fewer post-1969 split-interest trusts are being created because they (especially inter vivos charitable remainder trusts) are usually privately effected and often may not be known to the charity until termination. Even if it were conclusively shown that fewer such trusts were being created, one must also inquire whether the property not being placed in such trusts is staying in noncharitable hands or is finding its way to charity through other forms of charitable transfers.

On balance, it would be premature and unwarranted to conclude that the 1969 act provisions regulating charitable remainder trusts do not work in terms of either mechanics or policy. At present, efforts would best be spent attempting to simplify some of the details of the statute and regulations and to acquaint the legal profession as well as the public with the nature and availability of such trusts, rather than to undo the general structure of the provisions.

As the process of simplification and learning continues, one concrete step that can be taken would be to adopt legislation extending and enlarging the transitional rules permitting the reformation of charitable remainder trusts that would not otherwise qualify for tax deduction and exemption under the rules now applicable to such trusts. Although the charitable community and the bar have now had approximately five years to master the new concepts and requirements contained in the charitable remainder trust provisions of the 1969 act and the regulations thereunder, there are those observers who believe that the new requirements are so complex that additional time is still necessary:

> Public charities which rely on deferred (testamentary) giving face a difficult transition period until counsellors and estate planners familiarize themselves with the nuances of the new rules. As many re-educated lawyers and trust officers will testify, the new trust concepts in deferred giving are too complex to explain to clients and when the attempt is made, many clients forego their original plan for a smaller outright bequest. The transition period is made more difficult by the completely inadequate transitional rules which Congress installed to deal with the shift from the old style of deferred giving to the new trust concepts which it created. Many wills have been drafted after October 9, 1969, with old remainders simply because the lawyer was

uninformed or could not adequately explain, and draft, a testamentary trust which could withstand scrutiny of an estate tax examiner.[80]

Those who subscribe to the above views believe that the best solution would be for Congress to amend the Internal Revenue Code to permit unqualified trusts to be reformed and thereby fully qualified for all tax benefits. It is important to note, however, that such a proposal has been criticized in the past on at least two grounds. First, it runs counter to the traditional "one-bite" nature of the charitable deduction: that is, once the donor or testator has made or created the irrevocable split-interest gift or transfer, the tax implications of the transaction are fixed, and a substantive or technical failure to comply with the rules necessary for the desired tax treatment cannot be overcome by reforming or revising the transaction. Second, even the limited reformation or revision of an irrevocable trust raises rather basic policy questions relating to the legality and propriety, under local law, of such a judicial or contractual amendment for tax purposes. For example: Did the testator intend to qualify the trust as a charitable remainder trust? If so, what changes are necessary to so qualify the trust? If the changes are more than technical, do they shift substantive economic interests (for example, must the noncharitable interest be increased and the charitable interest decreased, or vice versa, to qualify; or must a power of invasion in favor of the noncharitable interest be removed to qualify)? If so, would the testator have intended that the economic interests be so shifted in order to qualify the trust as a charitable remainder trust? Is there more than one alternative method of revising the trust to qualify, and which (if any) would the testator have intended?

It should also be borne in mind that the complexities imposed upon charitable remainder trusts by the 1969 act have been so widely publicized and strongly critized that the Internal Revenue Service, in a break with its long-standing policy of refusing to publish and give advance approval to trust forms, prepared and published Revenue Ruling 72-395 containing a description of all of the provisions required to be included in the governing instrument of a charitable remainder trust, with samples of such provisions which will be acceptable to the Service. With this revenue ruling, a general practitioner unfamiliar with the intricacies of charitable remainder trusts ought to be able to draft such a trust which will comply with all of the requirements and thereby qualify for favorable tax treatment.

After reviewing the pros and cons of extending transitional relief to charitable remainder trusts that would otherwise not qualify for favorable tax treatment, it may still seem reasonable to conclude that the novelty and complexity of the rules now applicable to charitable remainder trusts warrant a more flexible approach to reformation than would ordinarily be allowed.

One possible approach would be to allow the creator of a charitable remainder trust to provide explicitly that the trustee may amend the governing instrument for the limited purpose of assuring compliance with the applicable sections of the Code and regulations. Thus, where the creator clearly intends to create a charitable remainder trust meeting all the requirements of section 664 of the Code and the regulations thereunder, allowing a subsequent limited correction of the governing instrument should pose little danger of violating the creator's intention. If more than a purely technical amendment were necessary, and shifts in the economic interests in the trust could result, such an amendment could be conditioned upon the consent of all the beneficiaries (if all the individual beneficiaries were adults and competent) and upon judicial approval. However, in considering such an approach, care must be taken to place some limitations on the type and scope of the revisions so that (1) substantial numbers of otherwise irrevocable and binding legal transactions do not suddenly become openended and fluid years later when it is determined that they failed to generate favorable tax treatment and (2) decedents will not have the provisions of their wills reformed or revised without the strictest judicial supervision and the most stringent limitations. While these potential adverse effects are ultimately matters of state law and supervision, the federal tax law must be written and administered in such a way as to recognize and curtail potential adverse results which might be encouraged by an overly broad and permissive federal tax provision, even though the ultimate decision as to the permissiveness is left to local authorities.

Footnotes

1. Such gifts are also subject to the rules applicable to charitable giving in general, including the provisions of the Code relating to appreciated and ordinary income property, percentage limitations for income tax deductions, bargain sales and allocation of basis, as well as many of the rules applicable to private foundations.

2. Code Section 170(f), Section 2055(e), Section 2522(c).

3. Joint Publication of Committee on Ways and Means, U.S. House of Representatives, and Committee on Finance, U.S. Senate, Part I, February 5, 1969, p. 183.

4. This report does not attempt to deal with the maze of provisions required by the regulations to be included in the governing instrument of a charitable remainder trust. For a description of such requirements and samples of provisions which will be acceptable to the Internal Revenue Service, see Rev. Rul. 72-395, 1972-2 *C.B.* 340.

5. Code Section 664(d); Treas. Reg. Section 1.664-2(d); Section 1.664-3(d).

6. Pooled income funds, for example, may be effected only with public charities.

7. Code Section 664(d); Treas. Reg. Section 1.664-1(a)(4). For special rules relating to the date of creation of testamentary charitable remainder trusts, see Treas. Reg. Section 1.664-1(a)(5).

8. Treas. Reg. Section 1.664-2(a)(3); Section 1.664-3(a)(3). When the trustee is given discretion to sprinkle the specified distribution among a class of beneficiaries, the beneficiaries may not include persons born after the trust is created unless the trust is established for a term of years. The policy behind this regulatory rule is unclear since the payout and term, whether measured by a period of years or by lives of individuals, will determine the amount of deduction allowable regardless of how the class of beneficiaries is defined.

9. Code Section 664(c); see also Code Section 512 and Section 514, and the Treasury Regulations thereunder for definitions of unrelated business income and debt-financed property, respectively.

10. Treas. Reg. Section 1.664-1(d).

11. See Treas. Reg. Section 1.1011-2. Whenever there is an agreement, express or implied, between the donor and the trustee to sell appreciated property contributed to the trust and to invest the proceeds in tax-exempt securities, the realized gain may be imputed and taxed to the donor under the principles of Rev. Rul. 60-370, 1960-2 *C.B.* 203.

12. Treas. Reg. Section 1.664-1(a)(3).

13. Unlike pooled income funds, charitable remainder trusts are not prohibited by the Code from investing in tax-exempt securities.

14. Treas. Reg. Section 1.664-1(d)(5).

15. Treas. Reg. Section 1.664-2(a)(4); Section 1.664-3(a)(4).

16. If the annuity amount is stated as a percentage, the instrument must provide for corrective payments to be made in the case of an incorrect valuation of the initial assets. Treas. Reg. Section 1.664-2(a)(1)(iii).

17. Treas. Reg. Section 1.664-2(b).

18. Treas. Reg. Section 1.664-2(c); Section 20.2031-10.

19. Senate Report 91-552, 91st Congress., 1st Session., 90. Since it is permissible to satisfy the unitrust amount by delivering assets in kind, it is questionable why this flexibility to choose these income options is allowed unitrusts but not annuity trusts which may face a similar need to invade corpus to satisfy the annuity amount. In fact, the income options had been originally proposed to apply to both annuity trusts and unitrusts, but the final version of the statute limited their application to unitrusts.

20. Joint Publication of Committee on Ways and Means, U.S. House of Representatives, and Committee on Finance, U.S. Senate, February 5, 1969, p. 193.

21. Treas. Reg. Section 1.664-3(b).

22. Treas. Reg. Section 1.664-4.

23. Rev. Rul. 72-438, 1972-2 *C.B.* 38. For purposes of this report, it is assumed that the charity "from time to time enters into agreements to pay annuities of a specified amount to individuals or their designees in exchange for money or other property . . . ." For other charities, see Treas. Reg. Section 20.2031-10.

24. Code Section 72.

25. Treas. Reg. Section 1.72-9 contains tables from which one can determine the expected return.

26. Rev. Rul. 72-438 does not deal with this question explicitly, however.

27. In hearings before the Senate Finance Committee, Dr. Roland C. Matthies, co-chairman of the "Committee on Gift Annuities" urged that gift annuities be specifically exempted from the bargain sale provisions of the House bill. The Finance Committee went further and deleted the bargain sale provisions from its bill entirely, on the ground that their enactment would "adversely affect giving to charities, as 'bargain sales' have been a long-accepted form of making contributions of property to charities." The Conference Committee restored the bargain sale provisions to the compromise bill in the same form as they had appeared in the House bill. And the Treasury, in its regulations implementing the provisions, explicitly applied them to gift annuities.

28. Rev. Rul. 62-136, 1962-2 *C.B.* 12.

29. For example, if the taxpayer transferred property with a basis of $5,000 and a fair market value of $10,000 to a charity in exchange for an annuity whose present value was $7,000, the transferor would have been required to report a gain of $2,000 in the year of exchange.

30. Treas. Reg. Section 1.1011-2(a)(4)(i).

31. The contrast between the two approaches can be seen from the following example:

A taxpayer transfers property with a basis of $5,000 and a fair market value of $20,000 at the time of transfer for an annuity with a present value of $10,000. Prior to the Reform Act, the taxable gain in the year of exchange would have been $5,000, representing the excess of the value of the annuity over the taxpayer's basis in the property transferred. Under the bargain sale provisions, only a percentage of basis equal to the present value of the annuity divided by the fair market value of the transferred property is allocated to the "sale" portion of the transfer. In the given example, since the value of the annuity is 50 percent of the fair market value of the property transferred, only 50 percent of the total basis, or $2,500 is allocated to the "sale" of property for the annuity. Thus, the taxable gain upon transfer is not $5,000, but $7,500. The remaining $2,500 of basis is allocated to the portion of the transfer representing the donor's contribution to charity.

32. As was the general rule prior to the Reform Act, the entire basis of the transferred property will be applied to the "sale" of property for an annuity, in determining the gain to be taxed on the exchange. See Treasury Reg. Section 1.1011-2(a)(1). Thus, in the given example, if the donor were not entitled to a charitable contributions deduction by reason of the transfer, the gain subject to tax would be $5,000, not $7,500.

33. Treas. Reg. Section 1.1011-2(a)(4)(ii).

34. See Treas. Reg. Section 1.1011-2(c).

35. Treas. Reg. Section 1.1011-2(a)(4)(iii).

36. These provisions were adopted in response to the Supreme Court decision in *Commissioner v. Brown*, 380 U.S. 563 (1965).

37. In testimony before the Senate Finance Committee, certain institutions of higher education from Pennsylvania urged that the House exception for annuities be clarified: "The life income contract and annuity agreement as used by our institutions is wholly distinct from the *Clay Brown* situation and the statute must be clarified if this unintended and unjustified side effect is to be avoided." (Senate Hearings, p. 1224.)

But the House bill was not so altered, either by the Senate or in Conference, and the House's exception thus emerged as the present Section 514(c)(5) of the Internal Revenue Code.

38. Code Section 514(c)(5).

39. Code Section 642(c)(5)(E); Treas. Reg. Section 1.642(c)-5(b)(6). There is no similar prohibition against a donor serving as trustee of a charitable remainder trust or a charitable lead trust.

40. Treas. Reg. Section 1.642(c)-5(b)(3).

41. Code Section 642(c)(5)(C).

42. Treas. Reg. Section 1.642(c)-6(a)(3) expressly refers to the bargain sale rules of Code Section 1011.

43. Treas. Reg. Section 1.642(c)-6.

44. Code Section 170(f)(2)(B).

45. Code Section 2055(e); Section 2522(c); Treas. Reg. Section 20.2055-2(e)(2)(v) and (vi).

46. Prop. Treas. Reg. Section 1.170A-6(c)(2); Treas. Reg. Section 20.2055-2(e)(2)(v) and (vi).

47. P.L. 91-172 Section 201; see also Joint Publication of Committee on Ways and Means, U.S. House of Representatives, and Committee on Finance, U.S. Senate, February 5, 1969, 183.

48. Treas. Reg. Section 1.170A-6(d).

49. Treas. Reg. Section 1.170A-6(c)(4).

50. Treas. Reg. Section 1.170A-6(d).

51. Treas. Reg. Section 1.170A-6(c)(3).

52. Prop. Treas. Reg. Section 1.170A-6(c)(2)(i)(c). See also Code Section 4947(b)(3).

53. Joint Publication of Committee on Ways and Means, U.S. House of Representatives, and Committee on Finance, U.S. Senate, February 5, 1969, p. 185.

54. Code Section 170(f)(3)(B); Treas. Reg. Section 1.170A-7(b)(3) and (4).

55. Treas. Reg. Section 1.170A-7(b)(4).

56. Code Section 170(f)(4).

57. Senate Report 91-552, 91st Congress, 1st Session, p. 89.

58. Code Section 170(f)(3)(B).

59. Treas. Reg. Section 1.170A-7(b)(1)(i).

60. Treas. Reg. Section 1.170A-7(c).

61. Rev. Rul. 73-339, I.R.B. 1973-34.

62. Rev. Rul. 64-205, 1964-2 *C.B.* 62.

63. Treas. Reg. Section 1.170A-7(a)(2)(i).

64. See *Eppa Hunton, IV*, 1 T.C. 821 (1943); Rev. Rul. 58-372, 1958-2 *C.B.* 99.

65. Section 170(e)(1)(A).

66. An individual's basis in a life insurance policy is his net premium cost: gross premiums less any dividends actually received and extra premiums paid for certain supplementary benefits. Rev. Rul. 55-349, 1955-1 *C.B.* 232.

67. Section 1011(b).

68. It has recently been reported that the Internal Revenue Service has refused to rule favorably on a split-dollar gift of an insurance policy similar to that held deductible by Rev. Rul. 69-79, *supra.* The Internal Revenue Service is said to have taken the position that the gift was of less than the taxpayer's entire interest in property, and that it could not be viewed as a gift of an undivided portion of the taxpayer's entire interest in property. 41 *Journal of Taxation* 319 (1974) ("Shop Talk" Column).

69. The same valuation principles described in this section would apply to valuation of charitable lead trusts.

70. These assumptions do conflict with certain "common-sense" analyses of the valuation tables. See, for example, Lehman, "Charitable Split-Interest Trusts in Estate Planning," 18 *Louisiana B. J.* 259,264 (1971): "One theory [why charitable deductions for similar-looking gifts vary] I have seen is that there is factored into the unitrust tables an expected future enhancement of the fund. That explanation does not make complete sense to me, because the stock market can go down as well as up; and second, even if it did go up, the value ultimately received by the charitable remainderman would likewise be increased."

71. The terms "interest rate", "rate of return," and "discount rate" are interchangeable synonyms for the same percentage figure. Their semantic differences do, however, highlight different facets of the valuation process. The "rate of return" emphasizes the fact that whatever interest rate is chosen is deemed to be the rate at which an investment will generate income. The "discount rate" emphasizes the fact that whatever rate is chosen will be used as the rate to reduce the value of a delayed gift to produce a figure which will equal the net present value of that delayed transfer. Since the value of a delayed transfer is measured by the lost opportunity to produce income by present control and possession of the funds (in all these calculations inflation is expressly ignored), the discount rate must, by assumption, be exactly equal to the rate of return. The term "interest rate" is merely another interchangeable term denoting the same figure.

72. This does not mean that the designated discount rate which must be used for calculations in valuing gifts made and deducted in 1973 cannot be changed for valuing gifts made in 1974. It does mean that a person preparing a return for a gift made in 1973 will expect to have to use just one per annum discount rate (subject to compounding) for valuing a gift's net present value regardless of whether the gift eventually will change hands in 1975 or 1985. Since the actuarial tables employed in making the valuation tables are estimates, not precise predictions, as to when

the noncharitable interest will terminate, there would only be a false accuracy in having several discount rates for split-interest gifts made in a given year.

73. The present 6 percent rate may be somewhat defensible as in line with historical interest rates and somewhat higher than the average earnings power of trust investments. One should also note that the operation of continuous compounding of the discount rate is calculated in a tax-free world unlike the financial environment in which the prime rate is set. Taxable investors obviously must demand a higher interest rate, *i.e.*, the prime, to protect their after-tax returns. Similarly, interest-paying entities which may deduct the cost of interest, do not effectively bear the full cost of the interest paid.

74. This assumes the payout rate is not increased to equal the increased discount rate. These conclusions have been confirmed by mathematical formulae prepared by Emil M. Sunley, Associate Director, Office of Tax Analysis, U.S. Treasury Department.

75. Since the Internal Revenue Code provides that the rate of return used in valuing a gift to a pooled income fund shall not be 6 percent but rather shall be determined from the actual earning power of the particular fund (unless it has been in existence for less than three taxable years in which case it is deemed to be 6 percent), a change in the rate from 6 percent to 9 percent would have no effect on seasoned pooled income funds.

76. While gift annuities are very similar in practical effect, the valuation tables for charities which grant annuities from time to time are based on the commercial cost of annuities, not on a particular assumed discount rate.

77. This result assumes that donors will not correspondingly increase the noncharitable payout.

78. The payout will actually be slightly over 6 percent. It is not exactly 6 percent because the size of the payout is measured by a valuation at the start of a year, not at the end of a year. Therefore, during the course of a year it is possible for 6 percent interest income not yet paid out to earn interest income upon itself.

79. One commentator has noted: "The cost of currently available annuities exceeds the value assigned to the annuitant's interest in an annuity trust paying a like amount under the new regulations." Ashby, "Charitable Remainder Trusts: The New Look," 11 *Trusts and Estates* 530 (1972).

80. Ibach and Lehrfeld, "Dysfunctions in Deferred Giving," *Trusts and Estates* (June 1974), p. 373.

Part II

Appreciated Property Deduction

LEGAL ASPECTS OF CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY TO PUBLIC CHARITIES

Harry K. Mansfield † and Ronald L. Groves †

Introduction

This paper's objectives are to present an analysis of the present federal income tax rules concerning the deduction for charitable contributions of all forms of appreciated property, a discussion of questions and problems raised by the present rules, a survey and analysis of some possible legislative alternatives for such contributions, and a brief description of some materials currently available evaluating the importance and effectiveness of the tax deduction.

The purpose of the paper is to provide a legal analysis of the topic. It does not purport to support or oppose any particular policy position, and it does not attempt to provide an economic analysis of the fiscal cost of the deduction or its value to charitable recipients. While the authors do have professional relationships with a number of concerned charitable organizations, they have attempted to present herein a fair and objective analysis for use in reaching substantive conclusions.

I

THE PRESENT RULES AND THEIR EVOLUTION

Pre-1969 History

Prior to the Tax Reform Act of 1969, a general principle was early established that an income tax deduction should be allowed for the *fair market value* of property contributed to charity. The charitable deduction was first enacted in the Revenue Act of 1917, which amended section 5(a) of the Revenue Act of 1916, by adding thereto a new clause "Ninth." Regulations 33 (revised) provided in Article 8, section 9, that "the amount of the gift is the fair market value of the property."

The statutory provision was reenacted in the Revenue Act of 1918 in section 214(a)(11), and Regulations 45 thereunder were originally issued in the same form as Regulations 33. However, based on L.O. 979,[1] T.D. 2966[2] was issued whereby it was stated in Regulations 45 (1920 Edition), Article 251, that "the amount of the gift is cost." This rule was promulgated for gifts made after February 28, 1913, the date of the original income tax enactment, although the regulation as revised was not promulgated until January 28, 1921. However, thereafter L.O. 1118[3] was issued, revoking L.O. 979. On June 21, 1923, T.D. 3490 amended Regulation 45, Article 251, and T.D. 3491 amended Regulation 62, Article 251, under the 1921 act, to reinstate the fair market value rule.

This general principle went substantially unchallenged until 1938, when the House of Representatives voted to limit the deduction to the adjusted basis of the property; but the Senate Finance Committee rejected this move in order to encourage charitable gifts.[4]

The first step away from the general principle was taken in the Revenue Act of 1962,[5] in which section 13(b) added section 170(e) of the Code, effective October

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16, 1962, to reduce the charitable contribution deduction by the amount that would have been recaptured under section 1245 had the contributed property been sold. Effective February 16, 1964, section 170(e) of the Code was further amended[6] to reduce the charitable contribution also by the amount of any section 1250 recapture. Aside from these limited exceptions, however, in 1969 the basic rule remained that the deductible amount was the fair market value of the property given.

Tax Reform Act of 1969

In General

Recommendations for tax reform as presented by the administration to Congress preparatory to consideration of the Tax Reform Act of 1969[7] were in two sets. The Johnson Administration presented its recommendations and then left office, whereupon the Nixon Administration presented its recommendations. With respect to property that would have produced ordinary income if sold, the Johnson proposal would have included the gain in ordinary income, whereas the Nixon proposal would have reduced the deduction. With respect to bargain sales to charity, the Johnson Administration proposal would have allocated basis, but the Nixon Administration had no proposal. With regard to sales at a gain to step up basis, the Johnson proposal would have carried over the basis, and the Nixon Administration had no proposal. With regard to the minimum income tax, the Johnson proposal was to adopt such a tax including the appreciation on charitable gifts; with regard to an allocation of deductions, the proposal was to take into account appreciation on charitable gifts. The Nixon proposals on these two items were initially the same but they were eventually dropped.

The House of Representatives voted, as in 1938, to limit the charitable deduction for all appreciated property to basis unless the taxpayer elected fair market value, in which case the gain would be included in his income as either ordinary income or capital gain. But the Senate was not prepared to go that far.

The final provisions of the 1969 act nonetheless extensively revised the deduction for charitable contributions of appreciated property. Under section 170(e)(1)(A), with respect to ordinary income property, the deduction was reduced by the amount of gain, as proposed by the Senate Finance Committee. With respect to tangible personal property unrelated in use, section 171(e)(1)(B)(i) provided that the deduction should be reduced by one-half the appreciation. With regard to gifts to private foundations, section 170(e)(1)(B)(ii) provided that the deduction should be reduced by one-half the appreciation. Finally, the deduction was limited to 30 percent for gifts of appreciated property to public charities even though the limitation of such gifts was otherwise raised to 50 percent, as provided in section 170(e)(1)(B). An allocation of basis was required with respect to bargain sales to charities under section 1011(b). As a result of these changes it can be said that it is no longer possible to derive from the tax statutes a basic rule for the deductible amount in the case of gifts of appreciated property to charity.

Contributions of "Ordinary Income Property"

Enactment of section 170(e)(1)(A). Pursuant to section 201(a) of the 1969 Act, section 170(e)(1)(A) of the Code now provides that any charitable contribution of property otherwise taken into account shall be reduced by the amount of gain that "would not have been long-term capital gain" if the property contributed had been sold by the taxpayer at its fair market value at the time of contribution. The contribution to charity of property falling within the purview of this provision will therefore effectively result in a contribution deduction not exceeding the cost or other adjusted basis of the property.

The Senate Finance Committee explained the concerns giving rise to the enactment of section 170(e)(1)(A) as follows:

> [I]n some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds. This is true in the case of gifts of appreciated property which would result in ordinary income if sold, when the taxpayer is at the high marginal tax brackets and the cost basis for the ordinary income property is not a substantial percentage of the fair market value. For example, a taxpayer in the 70-percent tax bracket could make a gift of $100 of inventory ($50 cost basis) and save $105 in taxes (70 percent of the $50 gain if sold, or $35, plus 70 percent of the $100 fair market value of the inventory, or $70).[8]

It should be noted that the taxpayer's true saving in the committee report example is $5, as the $100 in proceeds that he would have realized had he sold the property must be subtracted from the $105 in "tax savings" in order to reflect adequately the advantage gained from the contribution. In other words, had the taxpayer sold the item of inventory, he would have had gross proceeds of $100 and a $35 ordinary income tax, leaving net proceeds of $65. The contribution, on the other hand, although producing no immediate cash receipts, provided a $70 tax relief.

It should also be noted that the committee's example assumes that donated property would otherwise have been sold. While this is a logical assumption in the case of inventory, it may not be so in the case of certain other types of ordinary income property, for example, a work of art in the hands of the artist. If the donated property in the example had been of the latter variety rather than inventory, the potential for gain to the taxpayer from the donation would have been substantially more speculative.

It was nonetheless true before the 1969 act that a very high bracket taxpayer holding ordinary income proerty that he planned to sell could realize an immediate financial gain by giving the property to charity, and this made the contribution of ordinary income property one of the most obvious targets for reform. Under the 1969 act the taxpayer in the committee report example will be able to deduct only $50, his cost, and will consequently receive only a $35 tax benefit from the donation. Thus, because he could instead sell the property and retain $65 of the proceeds after tax, it is no longer possible for him to make a profit on the contribution. This is the result that Congress intended.

Scope of section 170(e)(1)(A). The Treasury Regulations under section 170(e)(1)(A) establish a class of property referred to as "ordinary income property" and define it as "property any portion of the gain on which would not have been long-term capital gain if the property had been sold by the donor at its fair market value at the time of the contribution to the charitable organization."[9] Examples of "ordinary income property" given by the regulations are inventory, works of art created by the donor, manuscripts prepared by the donor, letters and memoranda prepared by or for the donor, capital assets held by the donor less than six months, and stock described in section 306(a),[10] section 341(a)[11] or section 1248(a)[12] (to the extent that, after application of section 1248(a), gain on disposition of the stock would not have been long-term capital gain). The regulations point out that property used in a trade or business as defined in section 1231(b) will be treated as ordinary income property only to the extent that gain on sale would have been ordinary income under section 617(a)(1),[13] 1245(a),[14] 1250(a),[15] 1251(c)[16] or 1252(a).[17]

Special categories of ordinary income property: Inventory. It is perhaps in its application to inventory that section 170(e)(1)(A) has had its greatest impact on the flow of contributions to public charities. The donor of inventory – typically a corporate donor – now finds its contribution deduction limited to cost. In fact, such taxpayer often, as a practical matter, will not take any deduction under section 170; rather, the deduction will come in the ordinary course of business just as though the donated object had been sold. Under Regulation § 1.170A-1(c)(4), where costs and expenses pertaining to the donated property are incurred in the year of the donation and would be properly allocated to the cost of goods sold, such costs and expenses are treated as part of cost of goods sold and are not deducted under section 170.

Assume, for example, that in 1972 a corporation using the accrual method of accounting contributes to a public charity inventory items that it acquired in the same year at a cost of $500, and which on the date of donation had a fair market value of $800. Assume further that under the corporation's method of accounting, the $500 in cost is properly allocable to cost of goods sold. Had the corporation sold the items, it would have had ordinary income of $300; therefore, the contribution deduction must be reduced by $300, making the maximum deduction theoretically possible under section 170 $500. Under the regulations, however, the corporation will not claim that amount as a section 170 deduction but will treat the $500 as part of cost of goods sold and thus receive an equivalent deduction. Because the $500 is part of cost of goods sold, it cannot serve as basis for purposes of section 170(e)(1)(A), and the available section 170 deduction is consequently reduced to zero. On the other hand, the regulations require that costs and expenses incurred in a year prior to the contribution and properly included in inventory for the year of contribution be removed from inventory if they pertain to the donated property; such costs and expenses are therefore not part of the cost of goods sold for purposes of determining gross income for the year of contribution[18] and are deductible under section 170.

It is the contention of many charitable organizations that corporations and other former donors of inventory have simply discontinued their contributions entirely, rather than deal with the new restrictions. If this is the case, the charitable institutions most directly affected are seemingly those involved in the distribution of food, medicine, clothing, and other basic necessities. Several such institutions presented testimony on this problem to the Ways and Means Committee during its 1973 hearings on general tax reform. Included were the American Red Cross[19] and CARE,[20] the latter presenting evidence that its annual receipts of contributed inventory have fallen from values generally exceeding $3.5 million before 1969 to approximately $1.5 million in 1971 and 1972 (although there was an unexplained increase in such receipts in 1970).[21] Whether this kind of response is rational in light of the similar results of selling or scrapping the inventory or simply reflects annoyance at the incurrence of labor and costs of a charitable contribution producing only limited benefits cannot be determined here. In any event, the complaints of the affected institutions have given rise to a rash of legislative proposals designed to restore all or part of the tax benefits of inventory contributions.

Special categories of ordinary income property: Donor-generated art works and manuscripts. Prior to 1969, copyrights and literary, musical, or artistic compositions were already excluded from the statutory definition of capital assets if still in the hands of the person whose efforts created them or of a donee of such person. Consequently, such items were already of an "ordinary income" nature, and enactment of section 170(e)(1)(A) automatically limited to cost the deduction for their donation. On the other hand, such items as letters and memoranda were capital assets in the hands of their creators, and the new section 170(e)(1)(A) alone was insufficient to limit the deduction for the gift of those items. Congress, therefore, also provided in 1969 that letters and manuscripts in the hands of those who created them or for whom they were prepared would no longer be treated as capital assets.[22] The Senate Finance Committee explained its decision on this matter as follows:

> The rationale underlying the present law treatment of copyrights, artistic works, and similar property in the hands of the person who created them (or in the possession of a person who received the property as a gift from the person who created it) is that the holder of the property is, in effect, engaged in the business of creating and selling the artistic work or similar property (or is selling property created by the personal efforts of another who gave him the property). In view of this, gain arising from the sale of such property is treated as ordinary income derived as compensation for personal services rendered by the person (or the contributor), rather than as a capital gain from the sale of property held as a capital asset.
>
> The Committee believes that letters, memorandums, papers, etc. (or collections thereof) are essentially similar to a literary or artistic composition which is created by the personal effort of the taxpayer (or of the person who gave the property to the taxpayer), and should be classified in the same manner for purposes of the tax law. In the one case, a person who sells a book written by or for him is treated as receiving ordinary income for the product of personal efforts (i.e., compensation for personal services rendered). In another case, one who sells a letter or memorandum written by or for him is treated as receiving capital gain on the sale, even though the product he is selling is, in effect, the result of personal efforts.[23]

This area has also seen a recent clamor for legislation to alleviate partially the 1969 restrictions. The pressure has come primarily from libraries and art museums which feel that the 1969 changes have virtually eliminated contributions of works of art by artists and manuscripts by public figures. The record of the 1973 hearings on general tax reform contains considerable testimony on this subject. For example, the Library of Congress presented evidence that contributions of donor-generated manuscripts to both the Music Division and the Manuscript Division of the library have fallen to zero since 1970.[24] Here, too, the question may be raised whether such items have a ready market for sale at significant amounts. If not, these items are probably simply being destroyed or hoarded.

Special categories of ordinary income property: Insurance contracts. Life insurance contracts are not mentioned by the regulations among the examples of ordinary income property, but it appears that the sale of such contracts produces ordinary income[25] and that the deduction for their donation to charity is consequently limited to cost.

Contributions of "Capital Gain Property"

Section 170(e)(1)(B). While the pre-1969 abuse potential was neither as great nor as visible in the case of gifts of capital gain property as it was in the ordinary-income situation, Congress nevertheless decided in 1969 to restrict the deduction for gifts of capital gain items in two circumstances: (1) in the case of a contribution of tangible personal property, if the donee's use of the property is unrelated to the purpose or function constituting the basis of its exemption under section 501, or in the case of a governmental unit, to any purpose or function described in section 170(c), the deduction must be reduced by 50 percent (62.5 percent in the case of corporate donors) of the amount that would have been long-term capital gain had the property been sold by the donor at its fair market value at the time of the contribution;[26] (2) a similar 50 percent reduction must be made in the case of all contributions of appreciated capital gain property to private foundations other than those described in section 170(e)(1)(B).[27] The device of reducing the appreciation by 50 percent was adopted as a mechanism to achieve roughly the same result as if the donor had sold the property and contributed the proceeds.

"Unrelated Use": In general. The House version of the 1969 act proposed to take into account for tax purposes appreciation on, among other items, tangible personal property, without regard to the donee's use of the property.[28] The House would have subjected such property to the same rules that it had proposed for ordinary income property: the donor would have been entitled either to deduct cost or to deduct fair market value while electing to be taxed on the appreciation.[29] The Ways and Means Committee expressed concern that because of the complexities involved in the valuation of tangible personal property, particularly works of art, contributions of such items had often been the subject of abuse.[30] The committee appears to have had these valuation problems in mind in deciding to restrict deductibility to cost in the case of tangible personal property. The Senate Finance Committee, however, rejected this approach and, in its version of the reform bill, allowed the deduction for the full fair market value of tangible personal property donated to public charities to remain.[31] The Finance Committee felt that improved audit procedures rather than a cutback on the deduction was the answer to the valuation problem.[32] The unrelated use rule adopted in conference reached a result somewhere in between the House and Senate positions,[33] and the legislative history reveals little of the reasoning behind the rule. The provision hardly alleviates the problem of valuing tangible personal property: the full market value is still deductible if the donee's use is related, and even if the use is unrelated, valuation is necessary, as the reduction required is only a percentage of appreciation. The rule does insure that in the limited situation covered, it will no longer be more advantageous for the donor to give property to the charitable institution for sale by the institution than to sell it himself and donate the proceeds. However, this is inconsistent with the treatment of other types of property, as a taxpayer holding real estate or intangible personal property such as securities still receives an obvious advantage from contributing such property to a charitable institution that plans to sell it rather than selling the property himself and donating the proceeds.

The unrelated use rule, besides failing to solve the valuation problem, has been a source of some controversy and substantial technical difficulty. The questions, of course, revolve primarily around the meaning of "related." Regulation § 1.170A-4(b) (3) (i) seeks to answer the questions, in part, with the following illustration:

> For example, if a painting contributed to an educational institution is used by the organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use. If furnishings contributed to a charitable organization are used by it in its offices and buildings in the course of carrying out its functions, use of the property is not an unrelated use. The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization.

"Unrelated Use": Problems raised by the museums. When the above-quoted illustration first appeared in the proposed section 170 regulations[34] representatives of leading art museums deluged the Treasury Department with expressions of concern that the unrelated use rule, as interpreted by the regulations, would create insurmountable obstacles to their acquisition programs. They felt that the proposed regulations would be employed by the IRS to apply the unrelated use rule virtually any time a donated art object would be sold or exchanged by the donee institution and that donors would consequently place severe restrictions on the sale or exchange of donated property. These fears were not allayed by the provision in the proposed regulations stating that a donor may treat a gift of tangible personal property as not being put to an unrelated use if he establishes that the property is not in fact put to such use by the donee or if, at the time of the contribution, it is reasonable to anticipate the property will not be put to such a use.[35] The museums contended that donors would not want to be placed in the position of having to argue the reasonableness of their expectations regarding the gift and that they would find it much easier and safer simply to restrict their gifts.

The museums presented a convincing argument that the restrictions on the sale or exchange of donated art objects would deny their directors discretion in handling such art objects and that the discretion is essential to the sound functioning of a museum. The museums urged the Treasury Department to adopt a rule that would exempt from the definition of "unrelated use" exchanges for like kind items and sales where the proceeds were immediately to be reinvested in like kind property. The Treasury, however, felt that the statute did not permit this leeway and chose instead to include in the final regulations a more limited relief provision. In the final regulations, Treasury supplemented, as follows, the provision in the proposed regulations which granted relief to donees in cases where it is reasonable at the time of contribution to believe that the property will not be put to an unrelated use:

> In the case of a contribution of tangible personal property to or for the use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee.[36]

Thus, in the ordinary case, a donor of an art object to a museum need not restrict the donee's right to sell or exchange the property as long as, at the time of the contribution, the object is of the type that museums use for museum purposes. This, however, would appear at best to be only a limited solution, as special treatment for museums is difficult to justify under the statute.

Gifts to foundations. By operation of section 170(e) (1) (B) (ii), in the case of all contributions to or for the use of private foundations other than certain foundations described in section 170 (b) (1) (E) the amount of charitable contribution deduction must be reduced by 50 percent (62.5 percent in the case of corporate donors) of the amount of gain that would have been long-term capital gain had the property been sold. This restriction is, of course, significant to both foundations and potential donors of appreciated property. However, gifts to organizations other than public charities are not within the scope of this paper, which treats only gifts to public charities.

Bargain Sales

In general. Prior to the Tax Reform Act, a taxpayer holding property with a basis of $10,000 and a fair market value of $25,000 could bargain-sell it to charitable organization for $10,000 and would recognize no gain because the entire basis in the property could be used to offset the proceeds. At the same time, the taxpayer received a charitable contribution deduction of $15,000.

Section 1011(b), enacted as part of the Tax Reform Act, now requires such a taxpayer to allocate his basis in the property between the sale portion and the gift portion of the transaction.[37] Consequently, the donor in this example would be entitled to use only $4,000 of his $10,000 basis against the $10,000 proceeds received from the charity and would therefore be left with a gain of $6,000. He would still be entitled to a $15,000 charitable contribution deduction if none of the other reduction rules applied.

Interaction of sections 1011(b) and 170(e)(1). Regulation § 1.170A-4(c) (2) provides that where there is a bargain sale and section 1011(b) applies, for purposes of applying the section 170(e) (1) (A) reduction rule (i) there shall be allocated to the contributed portion of the property that portion of the adjusted basis that is not allocated under section 1011(b) to the "sale portion"; (ii) the amount of gain that must be recognized under section 1011(b) shall be determined; and (iii) the deduction shall then be reduced under section 170(e) (1) by the amount of gain that would have been ordinary income had the sale been at fair market value, less the amount of gain determined under (ii).

This rule may be illustrated by the example of taxpayer X who sells to a public charity for $10,000 inventory having a fair market value of $25,000 and in which X has a basis of $10,000. Under the regulation, section 1011(b) is not applied to the transaction, because even without regard to section 1011(b), X would not be entitled to a section 170 deduction; section 170(e) (1) (B) would require that the $15,000 contribution be reduced by the amount of gain that would have been ordinary income on the sale, that is, $15,000. On the other hand, if X sold the inventory to a charitable institution for only $5,000, the bargain sale rule would apply, because without regard to section 1011(b) he would be entitled to a charitable contribution deduction. Section 170(e) (1) (B) would require that the $20,000 contribution be reduced by the amount that would have been ordinary income on sale at fair market value, $15,000, leaving a deduction of $5,000. Consequently, $2,000 of basis would be allocated under section 1011(b) to the sale portion of the transaction, requiring X to recognize a gain of $3,000 on the sale. X would then, for purposes of computing the section 170 deduction, reduce the $20,000 fair market value by $12,000 in accordance with section 170(e) (1).

Special problems: Gift annuities. Prior to the 1969 legislation, certain charitable institutions, particularly small colleges and universities, relied heavily upon the sale of charitable gift annuities as a fund-raising device. In the typical transaction the donor transferred appreciated property to the charity in exchange for an annuity with an actuarial value equal to his basis in the property; he recognized no gain on the transaction, as his entire basis in the property was applied to the sale portion of the transaction. In some cases the value of the annuity received by a donor exceeded his basis, and the donor was required to recognize an immediate gain, but only to the extent of the excess.[38]

Regulation § 1.1011-2(a) (4) now provides that the bargain sale rule enacted in 1969 applies where property is sold or exchanged in return for an obligation to pay an annuity if a section 170 deduction is allowable as a result of the sale or exchange. Before the regulations were proposed in 1971, numerous colleges and universities urged the Treasury Department to exclude gift annuity transactions from the general scope of the bargain sale rule. They argued that Congress had not considered the effect of section 1011(b) on gift annuity transactions, but that it would have carved out those transactions had it focused on them. The institutions reasoned, first, that there is no assurance that an annuitant will live long enough to get back his cost basis in the property exchanged for the annuity and, second, that gift annuity transactions are primarily a tool of the small taxpayer whose motivations are principally charitable. The Treasury Department decided, however, that there was no authority in the statute for carving out gift annuity transactions by regulation, that those transactions were "sales" within the meaning of section 1011(b), and that the donor's basis must therefore be apportioned. The Treasury nevertheless sought to soften the impact of the bargain sale rule on gift annuity transactions by allowing the donor's gain on transactions involving non-transferable gift annuities to be recognized ratably over the taxpayer's expected life rather than immediately as would otherwise be required.[39] This has introduced to the gift annuity area an exceptionally complex apportionment requirement which is illustrated in Regulation § 1.1011-2(c), Example (8).

Special problems: Encumbered property. The regulations provide that if property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which the bargain sale rule applies, even though the charity does not agree to assume or pay the indebtedness.[40] This provision has been the subject of criticism from those who feel that the contribution of encumbered property should be treated as a bargain sale only when the encumbrance has been placed on the property as a step in the donative transaction. The critics argue that the statute does not authorize the present treatment and that the courts could overturn the regulations on this point.[41]

The Thirty Percent Limitation

While the 1969 act increased the general percentage limitation for charitable contribution deductions by individuals to 50 percent of a taxpayer's contribution base, a separate category was established for property on which long-term capital gain would have been realized by the donor if sold on the date of contribution and to which the reduction rules of section 170(e) do not apply. The deduction for contributions of property falling into this category is 30 percent of an individual taxpayer's contribution base.[42] A taxpayer's contribution base is defined as adjusted gross income computed without regard to any net operating loss carry-back to the taxable year involved.[43]

Where the taxpayer's contribution is to a private or semi-public[44] charity, or if it is "for the use of" any charitable organization,[45] a 20 percent limitation applies. While contributions to private foundations cannot be subject to the 30 percent limitation because all such contributions are within the scope of section 170(e), a contribution to a semi-public organization or a contribution of the use of appreciated property could theoretically be subject to both the 30 percent and the 20 percent limitations, in which event the smaller 20 percent limitation would be controlling.

Contributions of appreciated property to public charities that exceed the 30 percent ceiling may be carried over to subsequent years.[46]

It is possible for the taxpayer to avert the application of the 30 percent limitation by electing under section 170(b) (1) (D) (iii) to have the reduction rule of section 170(e) (1) (B) apply to the contribution. That election requires that the taxpayer reduce his contribution deduction by 50 percent of the amount that would have been treated as long-term capital gain had the donated property been sold. It is possible for this election to be of aid to the taxpayer nearing the 30 percent limit who wishes to make a contribution of property that has appreciated only slightly in value.[47]

II

SOME LEGISLATIVE ALTERNATIVES TO THE TREATMENT OF APPRECIATED PROPERTY

Since the enactment of the Tax Reform Act of 1969 the Treasury Department has adopted final regulations in virtually all areas where the act affected the deduction for contributions of appreciated property. In many cases the regulations have effectively answered the questions left by the act; in others, the problems remain, often because the Treasury does not have the statutory leeway to solve them administratively. In other words, even in regard to most of the narrow technical problems there is little more that can or will be done by regulation. Significant future changes with respect to contributions of appreciated property, whether relating to technical problems or to broad policy issues, will have to be through legislation.

Following is a brief description of some basic legislative alternatives in this area. Neither proposals for the elimination of the charitable deduction nor substitutes for the deduction are included. Rather, all the alternatives assume the continued existence of a charitable contribution deduction and are addressed specifically to the treatment of gifts of appreciated property. In examining the alternatives, it should be remembered that specific choices must be preceded by the threshold question whether the existing statutory framework as it relates to appreciated property is to be retained with amendments designed primarily to deal with technical difficulties and narrow policy issues or if an entirely new approach will be adopted. The answer to that question, in turn, hinges to a substantial degree on the more basic policy question whether the tax system will continue to be used to encourage charitable gifts of appreciated property and, if so, to what extent.

Retention of Existing Basic Framework with Specific Modifications

In General

If it is determined that as a matter of basic policy, the tax system should continue to be used as a significant means of encouraging charitable gifts of appreciated property, a sensible approach to legislation is to retain the present framework and make any specific modifications demanded by either technical or policy considerations.

Certainty of tax treatment is important in encouraging contributions, and any significant change in the statutory framework will undoubtedly create a period of uncertainty, even if the change is not intentionally designed to eliminate the existing advantages of giving appreciated property. The present framework, on the other hand, is now familiar to charitable institutions and donors, who, almost five years after enactment of the reform act, appear finally to be learning to work with it. Its retention, therefore, probably represents the most practical approach to continued encouragement of gifts of property.

Retention of the present framework does not answer the criticism that undue tax advantages are available to high-bracket contributors of appreciated property and that the current treatment of contributions of such property is inconsistent with a logical order in the tax system. Whereas specific amendments could perhaps partially alleviate the criticism regarding undue advantages, the same cannot be said in regard to the question of a logical tax system.

Possible Areas of Modification

The present framework does contain the existing technical difficulties and inconsistencies discussed in Chapter I. Legislation should presumably be aimed at eliminating those problems.

An obvious item for study is the inconsistency within section 170 in the treatment of various types of appreciated property. While complete consistency is probably neither necessary nor possible, certain irregularities such as the unrelated use rule of section 170(e) (1) (B) (i) and the resulting technical problems have been particularly troublesome.

Also affecting the issue of consistency but of greater potential impact is the policy question whether the deduction for gifts of ordinary income property will continue to be restricted to cost. As already noted, some prominent public charitable organizations appear to have found the ordinary income property rule damaging and have asked for legislative relief. The most frequently mentioned alternative within the existing framework is to permit the donor of ordinary income property to deduct, in addition to basis, at least 50 percent of his appreciation in the property. While such a change would obviously be applauded by charity, there are unquestionably others who would condemn it as a step backward since it would provide more favorable treatment of gifts of such property than if the property were sold.

The question of donor-generated manuscripts and art works is part of the larger ordinary income property issue. Since 1969, some bills have been introduced that would single out those items for more favorable treatment, but it seems far more likely that their fate will ultimately be determined by the general treatment of ordinary income property.

Finally, the bargain sale rule might also be an appropriate topic for further study. While the basic rule is seemingly satisfactory, the controversy engendered by its application to all gifts of encumbered property and the difficulties encountered by the Treasury Department in applying it to charitable gift annuities suggest the need for additional consideration of some particulars.

Return to Fair Market Value Standard

The optimum stimulant for gifts of appreciated property would be a return to the pre-1969 full fair market value standard. By permitting the full deduction for contributions of both ordinary income property and all types of capital gain property without regard to the amount of appreciation, this approach would also eliminate some of the inconsistencies introduced by the 1969 Act. However, the obvious,– and doubtlessly decisive – disadvantage of the full fair market value approach is that it would reinstitute the abuse potential with regard to appreciated property that was eliminated by the 1969 act.

Limitation of the Deduction to Cost in the Case of All Appreciated Property

If the basic policy decision is to discontinue the use of the tax system to encourage gifts of appreciated property to charity, the adoption of a cost standard is perhaps the most likely approach. This approach, which has been prominently urged by those who question both the fairness and the logic of the system, would essentially treat all contributions of appreciated property in the same manner that contributions of ordinary income property are treated under the 1969 act; in all cases the deduction would be limited to the donor's cost or other basis.

The cost standard has several advantages. To begin with, it offers consistency and simplicity. It would eliminate the general distinction in treatment between ordinary income and capital gain property as well as such narrower distinctions as that between tangible personal property put to an unrelated use and other types of capital gain property. More significantly, it would eliminate the often troublesome problem of valuing appreciated property, although an accurate determination of cost – also potentially troublesome – would become necessary in all cases.

From a policy point of view, the cost standard would virtually eliminate the advantages of giving appreciated property, and thus it would preclude the criticism that high-bracket taxpayers are being given an undue break with respect to such property. Furthermore, in the eyes of many critics of the present system it would be more in accord with the general order of the tax system.

The disadvantage of the cost standard is clear: Its adoption could logically be expected to curtail charitable contributions of appreciated property. If the 1973 testimony before the Ways and Means Committee regarding the impact of the Tax Reform Act on gifts of ordinary income property is an accurate indication of the effect of a cost standard, the curtailing effect of this approach on gifts of all other types of appreciated property could be expected to be sharp. Thus, the cost-standard approach, much more than any other, must be supported by the basic policy decision that the tax system is not to be used to encourage gifts of appreciated property.

Reduction of the Deductible Amount by a Uniform Percentage of Appreciation in the Case of All Appreciated Property

Another alternative is to adopt a rule permitting the deduction of a uniform percentage of the appreciation. If, for example, the reduction percentage adopted were 75 percent, a taxpayer contributing to charity real estate with a fair market value of $200,000 and a basis of $100,000 would have to reduce his deduction by $75,000, to $125,000.

This percentage-reduction approach is a variation of the cost-standard approach but would, depending on the percentage employed, have a less drastic total effect on gifts of appreciated property. For example, if a 50 percent standard were adopted, gifts to public charities of some items such as real estate and securities for which the full fair market value may now be deducted would presumably be adversely affected. However, gifts of ordinary income items to which a cost standard now applies would presumably be stimulated. Certain gifts of appreciated property already subject to a 50 percent standard would seemingly be unaffected. Were a 75 percent standard adopted instead, the total effect on giving would obviously be more adverse, but the treatment of ordinary income items would still be more liberal than it is now. A 25 percent standard would, of course, go in the other direction.

The primary advantage of the percentage-reduction approach is the flexibility demonstrated by the foregoing analysis. On the other hand, this approach would not do as much as the cost standard to simplify the treatment of gifts of appreciated property, as both the traditional problems of valuation and basis would remain. Furthermore, there are undoubtedly many who will argue that any percentage reduction whatsoever in the case of gifts of securities and real estate would be detrimental to private philanthropy.

Return to Fair Market Value Standard but with Tax on Amount of Appreciation as if Property Sold and Proceeds Contributed

Yet another approach would be to reinstate the full fair market value standard of deductibility while taxing the appreciation as if the donated property had been sold and the proceeds donated. A variation would be to tax only a portion of the proceeds.

This approach would allow a result roughly similar to either the cost-standard or the percentage-reduction method, depending on the applicable rate of tax and on the portion of appreciation taxed. Thus, the basic policy considerations are the same. On the technical side this approach, like the percentage-reduction approach, would lack some of the simplicity of the cost standard, as it would still require determination of fair market value in each case.[48]

Inclusion of Appreciation in the Minimum Tax in Year of Contribution

The possibility of including in the minimum tax the amount by which contributed property has appreciated in the hands of the donor can be considered independently of the basic rules now governing gifts of appreciated property, and has been considered by the House Ways and Means Committee. This approach, like some of the more direct approaches, presumably contains the potential for a curtailing effect on charitable giving. At the present level of the minimum tax, the effect would not appear to be radical, but both the structure and the rate of the minimum tax have also been under consideration by the Ways and Means Committee. Of course, any change in the minimum tax would in turn alter the potential effect of this approach.

Retention of Present Reduction Rules with Increase in Holding Period for Long-Term Capital Gain Treatment

An increase in the holding period necessary for long-term capital gain treatment would, under the existing reduction rule of section 170(e) (1) (A), potentially affect the treatment of gifts of all types of appreciated property. If, for example, the holding period were increased to 18 months, securities held for only a year would be treated as "ordinary income property," and their donation to charity would produce a deduction no greater than the donor's basis. This approach would have little technical effect on the basic rules now governing gifts of appreciated property. Its primary advantage is that it offers flexibility to the donor who would have some control over whether he would receive a deduction for cost in the case of recently acquired property or fair market value in the case of property held for the requisite period of time. On the other hand, this approach would not otherwise eliminate the problems in the existing system.

III

THEORETICAL AND POLICY CONSIDERATIONS

The attempt to ascertain the "right" solution for the income tax treatment of charitable contributions of appreciated property is often presented in the context of tax principles or tax policy. This can take the form of analyzing the tax treatment rules for various kinds of transfers of appreciated property and attempting to crystallize an appropriate single rule for all such transfers, including charitable transfers. It can also be approached as a matter of tax policy by taking account of the alternative courses of action available to a prospective donor in an endeavor either to equalize the tax treatment of the various courses or else to fix a sufficient tax benefit for lifetime charitable gifts to stimulate their production.

The above analyses are, of course, premised upon the present state of the legislative structure of the federal income tax as prescribed by Congress. A different approach might be based upon a concept of an ideal or pure income tax structure, which would require realization of income upon disposition of an appreciated asset. Under such an approach, there would be no justification for the fair market value deduction since any disposition of appreciated property, even by way of charitable gift, would require realization of the gain. We do not believe that this approach gives practical help to a present review of the question and therefore will not pursue it here.

Comparative Treatment of Transfers of Appreciated Property

If an individual transfers appreciated property to another party for cash or property, he will realize taxable gain or loss, capital or ordinary, unless specific statutory nonrecognition provisions apply. If an individual makes a noncharitable gift (or a contribution to the capital of a corporation), he does not realize income, although the donee must take a carryover basis (except in the event of a subsequent disposition at a loss). If the individual should suffer an involuntary dispostion by reason of his death, there likewise is no realization of income under present law, even though the recipient then takes the date-of-death value as his basis. There is also no realization of income upon the distribution of appreciated property by the trustee of a discretionary trust to the trust beneficiaries, nor in the case of a transfer of such property by a corporation to its stockholders (with certain statutory exceptions). An involuntary disposition of such property in the case of a casualty loss clearly does not yield income, even though it may yield a tax deduction. On the other hand, a gift of an installment obligation triggers income realization by virture of a specific statutory provision, and, pursuant to P.L. 93-625, the transfer of appreciated property after May 7, 1974, to a political organization will be treated as a sale by the transferor and taxed accordingly.[49]

Of course, these results do not answer the question whether a tax deduction should be granted for the appreciation even if there is clearly no income realization. In the case of an inter vivos noncharitable gift, and in the case of a trust distribution, perhaps the carryover of basis is the price of nonrealization. And in the case of a casualty loss, the deduction is the unreimbursed amount of the loss in value, but limited, however, to the property's basis.

Thus, there appears to be no support in other areas of the tax law involving transfers of appreciated property for derivation of a general principle that a fair market value charitable deduction is the proper rule in the absence of income realization. The closest approximation is the transfer of appreciated property on account of the owner's death, and needless to say, the circumstances there are quite different.

Alternatives for the Donor

Another way of examining the problem is to set out and compare the tax treatment and economic effect of alternative courses of action available to the prospective donor.

Gift of Cash

The donor could, of course, give the same amount in cash, which may or may not have been taxed to the donor as income. In any event, since cash always has a tax basis equal to its amount, it does not constitute a valid comparison with a gift of appreciated property.

Gift of Net Proceeds Following a Sale

The customary comparison is a sale of the asset by the donor and a gift of the net proceeds. A typical comparison is set out in the pamphlet, "How to Plan Your Giving to Harvard."[50] The Harvard pamphlet uses as an example the gift of 100 shares of stock that are worth $100 per share, or $10,000, bought more than 6 months ago at a cost of $20 a share, or $2,000. If these securities are sold in order to provide cash for a gift to Harvard, the donor will ordinarily have to pay a maximum tax of 25 percent (if his aggregate long-term capital gain in that year does not exceed $50,000) on the profit. This will amount to $2,000, leaving $8,000 to be given to Harvard. If the donor is in the 50 percent income tax bracket, the charitable deduction of $8,000 will result in an actual saving on his income tax of $4,000. Making the gift this way means that Harvard gets $8,000 at a *gross* cost to the donor of $6,000.

Instead of selling the stock, the stock can be given outright. The donor will then have made a gift of $10,000 instead of only $8,000, and there will be no capital gains tax due. The $10,000 gift will result in a saving of income tax of $5,000. Then the *net* cost to the donor is said to be only $3,000, which is the "net value" of the security, $8,000, less the income tax saving of $5,000. Harvard gets $2,000 more and the government $2,000 less, and the donor saves an additional $3,000. This analysis stems from the view expressed in the Harvard pamphlet that the donor should not consider the asset to be worth its full fair market value since it really has a reduced value because of the potential gains tax inherent in it. Of course, the donor really saves only an additional $1,000, which is the further reduction in his tax by reason of the extra $2,000 deduction; his gross cost has been reduced from $6,000 to $5,000 and his net cost from $4,000 to $3,000. The donor, however, has additionally transferred $2,000 from the government to Harvard.

Retention of Property or Proceeds of Sale

The donor does have the option of retaining the property rather than donating it. President Kingman Brewster of Yale has forcefully argued in support of the fair market value deduction on the basis of the donor's ability to avoid tax by retaining the asset.[51] This argument does not seem persuasive. It might argue against realization of taxable income upon the donation, but such an argument could be advanced even by the *seller* of appreciated property, as Professor Stanley S. Surrey of the Harvard Law School has pointed out. Compared with a charitable gift, retention of the asset deprives the owner of the deduction and thus would mean an increase in the owner's income tax.[52] Thus, retention has a tax cost which must always be balanced against the tax benefit of the deduction, whether the amount thereof is fair market value or tax basis.

More commonly, the result of a charitable donation is compared with a sale of property and retention of the after-tax proceeds. In the Harvard example, the individual could retain $8,000 compared with the tax benefit of $5,000 from a gift of the asset. He could gratify personal desires in the amount of $8,000 instead of making a charitable contribution of $10,000 at a net cost of $3,000. Clearly, a donor in that situation would appear to be charitably minded rather than selfishly inclined, since he is sacrificing $3,000 of potential personal expenditures to make the donation.

Particularly before the 1969 act, there were charges that the rule permitted a donor to obtain a net benefit, that is, to make money, by a charitable donation of appreciated property. That potential still theoretically exists but in very limited circumstances, as shown by a recent study.[53] If deemed necessary, special statutory provisions could be devised to eliminate even those possibilities.[54]

Other Gratuitous Transfers

While a gift of the property to a family member has been suggested as another alternative, the comparison is remote. The donor will not incur any income tax, but he may incur a gift tax; and the donee, as previously stated, takes a carryover basis. The fair market value charitable deduction, when available, simply offers an inducement toward a charitable beneficiary rather than an individual beneficiary.

Retention of the asset during lifetime with a testamentary gift to charity is another, and perhaps more realistic, alternative. The donor does not get the satisfaction of an inter vivos charitable gift, but he saves the net cost of such a gift by retaining the asset and continuing to enjoy any income therefrom. In this comparison the income tax deduction thus operates as an inducement to acceleration of the gift from death to lifetime.

Summary

Analysis of the treatment of other transfer situations in the income tax law fails to produce any principle to support the present deduction provisions, or indeed any specific alternative provisions. And, because of the many possible courses of action open to a prospective charitable donor, it does not seem possible or even desirable to attempt to equalize the income tax treatment of all such actions. The deduction must be analyzed and justified by charities and by the Congress solely in terms of an incentive to private philanthropy, leaving the merit of any particular legislative proposal to turn on the desirability and efficiency of the proposal.

Views of Some Tax Professors

Views on the subject of donating appreciated property to charity expressed by some recognized tax experts in leading law schools should be of interest and be considered.

Professor Surrey of the Harvard Law School has stated that in the 1969 act Congress recognized the "inconsistency" of allowing a full deduction for appreciated property. "Congress rejected the arguments of the colleges that somehow the exemption of the appreciation was consistent with tax logic." He states that the deduction is solely a matter of self-interest and that his "tax expenditure" approach is valid. In general, he believes that the full deduction should be eliminated but only after some alternative providing adequate charitable support is found.[55]

Professor William D. Andrews, also of the Harvard Law School, in viewing the 1969 act provisions has stated, "Present law generally allows a deduction of fair market value." Professor Andrews agrees that his theoretical arguments in support of certain personal deductions, *including the charitable deduction*, will not, however, support the rule of a fair market value deduction for appreciated property and concludes that the fair market value rule must be viewed as a subsidy.[56]

Professor Paul C. McDaniel of the Boston College Law School states that the 1969 act aggravated the problem for capital assets. Under his proposed matching grant system, Professor McDaniel prefers matching on the basis on the *present rules* of section 170(e), which reflect current congressional evaluation of the proper deductible amount. He further states, "It leaves the larger question of the proper treatment of transfers of appreciated property to charity to be resolved in the context of proposals dealing generally with donated transfers of appreciated property."[57]

Professor Boris Bittker of the Yale Law School recommends "reexamination of the deductibility of the fair market value of appreciated capital assets, without recognizing the gain, only in the context of general realization of appreciation by gift and at death." He suggests comparing the charitable gift not with a sale of the asset but with inter-family transfers. He states that even if inter-family transfers are changed, "I would give more weight to the practical consequences of a change than to its contribution to 'tax purity,' 'tax logic' or definitional elegance."[58]

Finally, Professor Lawrence M. Stone of the University of California Law School at Berkeley stated that the importance of the fair market value rule is "highly overrated." He suggested that limiting the donor's basis to cost is less desirable than treating the gift as a realizing transaction because of gifts of art works and the like.[59]

Many others have also commented on this subject, of course, but these individuals have discussed the matter more fully and recently.

The Effect of the Deduction as an Inducement

Since the conclusion has been reached herein that a charitable deduction for the fair market value of appreciated capital assets is only defensible as a desirable inducement for the transfer of privately owned property to charities, the effectiveness of the inducement will be an important factor in considering its retention or its replacement by some alternative. The approach to ascertaining that information has been primarily two fold: one is to subject to an economic analysis statistics from returns and income data, and the other is to poll samples of donors to ascertain their reactions to elimination of or changes in the charitable deduction. As stated at the outset, this paper is limited to a legal analysis of the subject, and so it does not attempt to analyze or even survey the literature on this aspect of the subject.

During the 1973 hearings before the Committee on Ways and Means on general tax reform, many charitable organizations and representatives presented testimony as to their belief of the need for retaining, or even restoring, tax incentives for charitable giving. While most of the testimony was assertive, without much foundation in hard data, there were significant presentations by some as to the importance of gifts of property[60] and by others, such as museums, as to the adverse effects of the 1969 act upon gifts of art or manuscripts by artists and authors.[61]

There can be little doubt that the present income tax deduction for the fair market value of appreciated property is an incentive of considerable impact, but its efficiency has not been quantified with precision.

Footnotes

1. 2. C.B. 148

2. T.D. 2966 was subsequently superseded by T.D. 2998.

3. II-1 C.B. 148.

4. See S. Rep. No. 15-67, 75th Cong. 3rd Sess. p. 14.

5. P.L. 87-834.

6. P.L. 88-272, section 231(b) (1) (A).

7. P.L. 91-172.

8. S. Rep. 91-552, 91st Cong. 1st Sess. pp. 80-81

The committee report continues as follows:

> The committee does not believe that the charitable contributions deduction was intended to provide greater – or even nearly as great – tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity. Moreover, an unwarranted tax benefit is allowed these taxpayers, who usually are in the very high income brackets. The committee, therefore, considers it appropriate to narrow the application of the tax advantages in the case of gifts of certain appreciated property. *Ibid.*

9. Reg. § 1.170A-4(b)(1).

10. In general, section 306 stock is certain stock which the shareholder has received as a nontaxable stock dividend or as a stock distribution in connection with a tax-free reorganization. "Section 306 stock" is defined in section 306(c).

11. Section 341(a) deals with collapsible corporations.

12. Section 1248(a) deals with certain foreign corporations.

13. Section 617(a) (1) deals with recapture of mining and exploration expenditures.

14. Section 1245(a) deals with recapture of depreciation on certain depreciable property.

15. Section 1250(a) deals with recapture of depreciation on certain depreciable realty.

16. Section 1251(c) deals with recapture on certain farm property.

17. Section 1252(a) deals with recapture on disposition of certain farmland.

18. Reg. § 1.170A-1(c) (4).

19. Public hearings on general tax reform before the Committee on Ways and Means, House of Representatives, p. 6172 (1973).

20. Ibid. p. 6170.

21. See also testimony of Maurice Gray. Ibid. p. 6475.

22. Section 1221(3).

23. S. Rep. No. 91-552, 91st Cong. 1st Sess. p. 191.

24. Public Hearings, note 19, *supra*, p. 6287.

25. See, *e.g.*, *Gallun v. Commr.*, 327 F.2d 809 (4th Cir., 1964); *Commr. v. Phillips*, 275 F.2d 33 (4th Cir., 1959); *Jones v. Cor.*, 39 T.C. 404 (1962); *Arnfeld v. United States*, 163 F.S. 865 (Ct. Cl., 1958), *cert. den.* 359 *U.S.* 943.

26. Section 170(e) (1) (B) (i).

27. Section 170(e) (1) (B) (ii). The foundations described in Section 170(b) (1) (E) are private operating foundations, conduits and community foundations qualifying as 50 percent organizations.

28. See H.R. Rep. No. 91-413, 91st Cong. 1st Sess. p. 55.

29. Ibid.

30. The committee report expressed the concerns of the committee as follows:

> Works of art, such as paintings, are one of the types of items which frequently are given to charities, and in which there often is a substantial amount of appreciation. The large amount of appreciation in many cases arises from the fact that the work of art is a product of the donor's own efforts (as are collections of papers in many cases). Works of art are very difficult to value and it appears likely that in some cases they may have been overvalued for purposes of determining the charitable contribution deduction. Ibid.

31. S. Rep. No. 91-552, 91st Cong. 1st Sess. pp. 81-82.

32. The committee report contains the following explanation:

> The committee considers it appropriate to treat gifts of tangible personal property (such as paintings, art objects, and books not produced by the donor) to public charities and schools similarly to gifts of intangible personal property and real property. Moreover, the committee believes that the serious problems of valuation of gifts of tangible personal property would still remain even if the appreciation were to be taken into account for tax purposes, and that a more desirable method of controlling overvaluations is for the Internal Revenue Service to strengthen its audit procedures for reviewing the value claimed on such gifts. Special consideration is warranted even in the case of smaller contributions than those which presently are closely reviewed by the Commissioner's advisory panel on valuation of art objects. Ibid., p. 82.

33. See Conf. Rep., H.R. Rep. No. 91-782, 91st Cong. 1st Sess. pp. 293-294.

34. Prop. Reg. § 1.170A-4(b) (3) (i).

35. Prop. Reg. § 1.170A-4(b) (3) (ii).

36. Reg. § 1.170A-4(b) (3) (ii).

37. The new bargain sale provision was placed in the reform legislation by the Ways and Means Committee which used the following example to illustrate its concern about the existing rule:

> The tax saving available in the case of a bargain sale of property to a charity may be illustrated by the example of a taxpayer in the 70-percent tax bracket who makes a sale of inventory with a value of $200 to a charity at its cost of $100. The taxpayer in this

> case would save $140 in taxes with respect to his $100 charitable gift (70 percent of the $100 gain if sold, or $70, plus 70 percent of the $100 of appreciation taken as a charitable deduction, or $70). H.R. Rept. No. 91-413, 91st Cong. 1st Sess. 54.

The Senate Finance Committee disagreed with the House restrictions on bargain sales, saying that they would adversely affect giving to charities, as bargain sales had been a long accepted form of making contributions of property. S. Rept. No. 91-552, 91st Cong. 1st Sess. 82. The Conference Committee adopted the House version.

38. Rev. Rul. 62-136, 1962-2 C.B. 12.

39. Reg. § 1.1011-2(4) (ii).

40. Reg. § 1.1011-2(3).

41. The Committee on Personal Income Taxation of the New York State Bar Association Tax Section, in its 1971 Comments on the proposed section 1011(b) regulations, made the following argument against the inclusion of all donations of encumbered property within the scope of the bargain sale rule:

> The legislative history of section 1011(b) provides no guidance as to whether and when the contribution to charity of encumbered property is, or is not, to be treated as a bargain sale falling within the ambit of that provision. Sections 514(c) (2) and 4941(d) (2) (A), also added to the Code by the 1969 Act, confirm a congressional awareness of encumbered property contribution problems but provide no direct assistance in construing the bargain sale provision. However, the section 514 effective date provision, § 121(g) of the 1969 Act, in the manner of its use of the term 'bargain purchase', does not view the mere contribution of encumbered property, without more, as giving rise to a bargain purchase or, complimentarily, to a bargain sale.
>
> The language of section 1011(b) is narrow, requiring for its application a threshold determination that a charitable deduction is allowable by reason of a sale.' While the legislative history of the provision, other than by analogy to Act § 121(g), is uninformative, the background of decisional law is more helpful. The donation of mortgaged property has been held a sale when the mortgage was placed upon the property in contemplation of and as a step in the plan of contribution. *Magnolia Development Corporation*, 19 T.C.M. 934 (1960); *Joseph B. Simon*, 32 T.C. 935 (1959), *aff'd*, 285 F.2d 422 (3d Cir. 1960); *Irvine K. Furman*, 45 T.C. 360, 367 n 10 (1966), *aff'd per curiam*, 381 F 2d 22 (5th Cir. 1967). However, there does not appear to be judicial authority for the proposition that a mere contribution of mortgaged property, not encumbered as a step in the plan of donation, is to be treated as a sale, and the grounds of decision of the cited cases are inconsistent with that simpler formulation.
>
> Recently, the Internal Revenue Service promulgated two rulings bearing upon the point in issue. The first dealt with a charitable contribution of property encumbered in excess of the donor's basis in a situation in which it was unclear whether the property had been encumbered with a view to the subsequent gift. In Rev. Rul. 70-626, 1970-50 I.R.B. 21, the Service held the donative transfer to have resulted in realization of gain by the taxpayer in the amount by which the encumbrance exceeded his basis in the property. The ruling does not refer to section 1011(b) since the year of the gift was 1968. The ruling did not characterize the transaction as a 'sale' and thus it is not directly in point here. The mortgage in excess of basis case presents an issue distinguishable from that which is the subject of this comment and, as the cited ruling confirms, gain properly may be recognized on the donation without resort to section 1011(b).
>
> However, in Rev. Rul. 71-232, 1971-21 I.R.B. 11, the Service, considering a non-charitable gift of property in connection with which the donee was obliged to pay the gift tax, viewed the transaction as a gift in part and a sale in part. This ruling, which is consistent with the encumbered property position taken in the proposed bargain sale regulation, is inconsistent with judicial authority on the point, *Richard H. Turner*, 49 T.C. 356 (1963), *aff'd per curiam.* 410 F.2d 752 (6th Cir. 1969). The decision in *Turner* is

> neither ancient nor obscure, and the failure of the Service to advert to it in the recent rulings, and the proposal of a bargain sale regulation essentially contrary to the decision, suggest that the Treasury's proposed regulatory position embodies a questionable substantive policy that the statutory reference to 'sale' would not, in any event, easily support.

It should be noted that *Turner*, the case relied upon in the quoted comment, has been substantially weakened by the decision in *Johnson* v. *Commr.*, 495 F.2d 1079 (6th Cir., 1974). While *Johnson* is factually distinguishable from *Turner*, the Sixth Circuit went beyond the facts to limit the precedential value of its own opinion in *Turner*. In *Hirst* v. *Commr.*, 63 T.C. No. 27, however, the Tax Court again relied on *Turner* and suggested that the Sixth Circuit was mistaken in *Johnson* to have given *Turner* a restricted interpretation.

42. Section 170(b) (1). These rules do not apply to corporations, as all corporations are subject to a 5 percent limit. Section 170(b) (2).

43. Section 170(b) (1) (F).

44. "Semi-public" charities may be defined as a limited category of organizations which neither meet the public charity requirements of section 170(b) (1) (A) nor the section 509(a) definition of private foundation.

45. In general, a contribution of an income interest or of a remainder interest in income only is "for the use of" an organization. Reg. § 1.170A-8(a) (2).

46. Section 170(b) (1) (D) (ii).

47. See Reg. § 1.170A-8(d) (2).

48. It can be argued that an approach requiring realization of full appreciation on donated property is less desirable than the cost-standard approach because it fails to eliminate the valuation problem while rendering similar results. However, Professor Stone, note 59 supra, argues to the contrary. He points out that under the cost standard a taxpayer would be tempted to sell at fair market value, report his capital gain and subsequently make a cash gift to charity which would be deductible against ordinary income. Were the same taxpayer to donate the appreciated item directly to charity, he would not be able to so take advantage of the rate differential. Thus, argues Professor Stone, under the cost standard charitable institutions such as museums might be deprived of desirable art objects that they would otherwise receive.

49. Section 84. Because the transfer to a political organization is treated as a sale, the organization gets a step-up in basis. Consequently, the ultimate effect of section 84 is to transfer the income tax burden from the donee to the donor, as the I.R.S. had, in Rev. Rul. 74-323, 1974-2 I.R.B. 8, taken the position that a candidate selling appreciated political gifts must report the net gain on Form 1041 and pay any tax due. (However, Rev. Rul. 74-323, by its terms, did not apply to sales of appreciated political gifts before October 3, 1972, the date on which the Service announced in News Release No. 1257 that it would consider the tax consequences of such sales. In enacting PL 93-625, Congress then gave political organizations an additional grace period by prohibiting the application of the ruling to sales taking place prior to August 2, 1973. Thus, appreciation on political gifts disposed of before that date escaped tax at both the transferor and transferee levels.)

50. "How to Plan Your Giving to Harvard" (1970 ed.) pp. 9-10.

51. Letter printed in the Congressional Record of September 18, 1969, 115 Congressional Record 26,202.

52. Stanley S. Surrey, *Pathways to Tax Reform* (Harvard University Press, 1973), p. 371.

53. John W. Byrnes, *Tax Reform and Financing Higher Education* (1973).

54. Adam Yarmolinsky, *Private Philanthropy in International Affairs.*

55. Surrey, op. cit., pp. 223-232.

56. Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Rev. 309, 344-375 (December 1972).

57. Paul R. McDaniel, "Federal Matching Grants for Charitable Contributions," 27 Tax L. Rev. 377 (Spring 1972).

58. Boris I. Bittker, "Charitable Contributions: Tax Deductions or Matching Grants," 28 Tax L. Rev. 37 (Fall 1972).

59. Lawrence M. Stone, "Federal Tax Support of Charities," 1968 U.S.C. Tax Institute 27.

60. See, for example, the presentation by the American Council on Education and related organizations, Public Hearings, note 19, supra, pp. 5515-5640.

61. For example, the testimony of Associated Council of Arts and related organizations, Public Hearings, note 19, supra, pp. 6021-6147.

A PRO-CHARITY SUBSTITUTE FOR THE PRESENT LAW TAX TREATMENT OF APPRECIATED PROPERTY CONTRIBUTED TO CHARITY

Gerard M. Brannon †

Introduction

Present U.S. tax law permits contributors to deduct the market value of appreciated property contributed to charity without any imputation of gain.[1] This provision is a violation of consistent income accounting even if one concedes the principle of a deduction of gifts to charity. (See Section 1, below.) This preference[2] is particularly inequitable because of its concentrated effect for the very rich, (Section 2), but it is retained for its effectiveness in inducing a higher level of contributions (Section 3). A requirement for imputing gain on gifts of appreciated property would in the aggregate have relatively small effects on charities, but the political muscle of this group would probably be enough to block simple removal of the preference (Section 4). This leads us to propose an alternative supplement to the charitable contributions deduction which would be less inequitable (Section 5) and more effective in inducing contributions (Section 6).

Section 1: We can see clearly that the present law failure to impute gain on gifts of appreciated property is a tax preference by comparing this gift with the cash gift. A taxpayer contributing cash is giving up dollars that are fungible with the dollars that have been included in his income (as salary, interest, etc.). Contributing cash to charity is equivalent to waiving some income in favor of letting it go to charity. A tax deduction amounts to government waiving the tax that would have been due on that income.

If the gift is appreciated property, and is deducted at market value without imputation, then the taxpayer is deducting from income something (viz. the appreciation) which never was in income. This is a distortion from proper accounting practice.

To illustrate these points, we assume taxpayer A who has salary income at 10 per month. We also assume that A sets aside the January income for purchase of asset X, which rises to a value of 30 by December when it is contributed.[3] For the year, A has income available for living expenses, before tax, of 110, the 11 months of salary not contributed. Under present law A reports taxable income of only 90. That this difference between income available for living expenses, before tax, and taxable income is a distortion can be seen by comparing A's results with a few variant cases. B, with the same salary income, contributed his January check straight away. B has as much to live on (11 months of income) as A but pays tax on 20 more than A pays tax on. C with the same income contributes three months salary all in cash, as much value as A contributed. C has the same taxable income as A but only 90 for living expenses while A could live well on 110. The closest parallel to A's situation is taxpayer D who earned salary of 140 and contributed 30 in cash. Like A, taxpayer D has 110 of income before tax to live on but under present law D pays tax on 110 while A pays tax on 90.

That A and D should have more similar tax treatments is indicated by considering how they would be treated if neither had made a contribution. (We assume that A sold the asset that appreciated between January and December but used the proceeds for living expenses.) In this situation A and D would report the same income except that A would have whatever advantage that the Congress sees fit to give him because his income arises from the favored form of capital gains. If we start from this equality clearly the right treatment of A (so far as the contribution is concerned) is to subtract 30 from whatever the income would be if the gain has been used for living expenses.

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These several cases are summarized in Table 1.

Table 1
Treatment of Several Taxpayers with Contributions, With and Without Appreciation

	Taxpayer			
	A	B	C	D
1. Ordinary income from salary	120	120	120	140
2. Cost of gift property	10	10	30	30
3. Value of gift on delivery	30	10	30	30
4. Contribution deduction	30	10	30	30
5. Taxable income - present law (1-4)	90	110	90	110
6. Income available for personal expenses, before tax (1-2)	110	110	90	110
7. Taxable income with imputed gain less 50% exclusion	100	110	90	110

Section 2: Due to the simple arithmetic of combining probabilities, this generous treatment of contributions of appreciated property is extremely biased toward favoring wealthy contributors.

Assume that the probability of a taxpayer in the lowest income bracket having a realizable capital gain is 0.05 and that the probability of a taxpayer in that bracket taking a deduction for charitable contributions is 0.1. Assume further that the corresponding probabilities for taxpayers in a high income bracket is each 10 times larger, that is, the probability of capital gains 0.5 and of a contributions deduction 1.0. The combined probabilities of a taxpayer having both a realizable capital gain and an itemized charitable deduction is 0.005 in the lowest bracket and 0.5 in the high bracket, or 100 times greater in the high bracket.

That this simple calculation is broadly realistic is suggested by the following specific individual and combined probabilities based on preliminary data from Statistics of Income for 1972:

Table 2
Probabilities, Separate and Combined for Itemizing Deductions and Realizing Capital Gains

	Probability of		
AGI Class	Itemized Deductions	Capital Gains	Both
Under $5,000	0.053	0.042	.0022
$10,000-15,000	0.516	0.106	.0546
$50,000-100,000	0.960	0.515	.4944
$1,000,000 up	0.996	0.866	.8625

Source: Statistics of Income Individuals, 1972, Preliminary, Internal Revenue Service.

The top-bracket taxpayer has 400 times greater chance to utilize this tax preference than the low-bracket taxpayers. Even the $50,000 to $100,000 class has a nine times greater opportunity than the $10,000 to $15,000 taxpayer.

These calculations don't measure use of the appreciated property contribution deduction but only the presence of essential conditions. The whole arrangement is more discriminatory because gifts of this sort involve some transfer cost and thus are unlikely to be suitable for the normal contribution situation of the low-income wage earner, the Sunday collection in church or the payroll deduction for a U.G.F.

Some empirical confirmation of these inferences about applicability of preferences for appreciated property contributions is offered by a highly respected interview survey. The portion of respondents reporting gifts of appreciated property rose from 3 percent at incomes of $1,000 to $15,000 (in 1964 prices) to 32 percent at incomes of $75,000 to $150,000 and to 62 percent at incomes over $150,000.[4]

Apart from the inherent unfairness, this special preference for a particular kind of contributions of the rich aggravates a system in which the contributions of the rich already enjoy a substantially greater government subsidy per dollar contributed than do the contributions of the poor.[5]

Over and above the fairness isssue, the present treatment of gifts of appreciated property is also likely to be an erratic influence in the art market, serving to underwrite speculative movements in art prices. The argument, briefly, is that ordinarily speculative booms in a market price are aborted because of a budget constraint operating through buyers. In the art market, the government, so to speak, has an open-ended subsidy arrangement for gifts of art works of appreciated value to museums. The higher that speculation drives up the price, the higher is the subsidy which is keyed to a donation of the appreciated work to museums.[6]

Section 3: The present treatment of charitable gifts of appreciated property is clearly retained in the tax law because it is deemed to be especially effective as an incentive for giving, which is why the Senate Finance Committee rejected a House amendment in 1938 that would have limited deduction to the lower of cost or market. We know of no careful study of the precise character of this special effectiveness. There is ample assertion of opinion,[7] but why this is so is a matter of importance if we are to consider substitutes.

The theoretical problem at issue here is that gifts of appreciated property have several unique characteristics: (1) they produce more tax saving than an equivalent gift of cash; (2) their tax benefits go more to the rich; and (3) their tax benefits go more to people who own large amounts of wealth compared to their income. It is a matter of some importance how many of these circumstances are relevant to the extra gift inducing property of the present treatment of gifts of appreciated property.

Let us assume that the failure to tax appreciation on these gifts involves a revenue loss of $200 million.[8] It can be safely assumed that providing an extra $200 million of tax benefits connected with contributions would increase the level of contributions, however this was done. Consider three alternative ways of losing this much revenue:

1. A portion (about 20 percent) of all taxpayers taking charitable contribution deductions last year could be selected at random and told that they could deduct $12 for each $10 contribution in the current year.

2. All taxpayers with AGI over $100,000 would be permitted to deduct $12 for each $10 contributed.

3. All taxpayers whose wealth exceeds three times their income would be permitted to deduct $12 for each $10 contributed.

Technique (1) could be expected to simply multiply whatever effect on contributions is realized from the current deductions in the same portion that it multiplies the revenue loss. If a revenue loss of $4 billion from contributions deductions increases contributions by say $3 billion,[9] this additional deduction randomly distributed would have a revenue loss of $200 million and a contributions effect of $150 million.

Technique (2) differs from Technique (1) in that it concentrates its effect on the rich. If the rich are more responsive in added contributions per dollar of tax saving than would be low-and middle-income taxpayers, then Technique (2) would produce more added contributions bang for the revenue buck lost, compared to Technique (1).

Technique (3) concentrates on people whose wealth is high relative to income. Plausibly, these people would be more inclined, than the average, to increase giving when tax preferences increase because giving out of wealth does not mean much current consumption foregone.

It is easy to see that our three bizarre techniques for making the deduction for contributions more generous correspond to the three potential reasons offered above to explain how the present law treatment of gifts of appreciated property may be particularly effective in increasing contributions. The reason for emphasizing this parallel between theories and techniques is that we are ultimately concerned with designing an alternate "extra" benefit on the charitable contributions deduction and we will need to ask whether the new extra benefit is as likely to increase contributions as the old one. To answer this question, we need to know precisely how the old extra benefit induced extra contribution. Thus if the present law treatment of gifts of appreciated property stimulates charitable contributions merely because it goes almost exclusively to high-income people or people with property, then any alternate extra benefit will lose in effectiveness in inducing additional charitable contributions precisely to the extent that it reduces the concentrated benefit for high-income people or propertied people.

We are inclined to dismiss out of hand the theory underlying Technique (3), that the present law extra benefit for charitable contributions works because it concentrates extra deductions on people who own a lot of property. In the first place, there is no evidence which bears on the relative response to tax incentives between those whose income is mostly from salary and wages and those whose income is mostly from property.

Even if we had some evidence that persons with relatively large wealth were more sensitive to tax incentives for contributions than people with non-property income, we would be inclined to dismiss the long run importance of this because people with relatively more property are likely to make charitable bequests at death and increased lifetime contributions are likely to be no more than anticipations of testamentary dispositions.

We are left with the difference in contributions effects between Techniques (1) and (2) as the critical issue in whether the revenue loss of $200 million from the present law treatment of gifts of appreciated property induces more contributions than would be induced by a random increase in deductibility that involved a revenue loss of $200 million.

We think that it is plausible that high-income individuals increase their contributions more per dollar of revenue loss on contribution incentives than do low-income individuals. In economic terms this is an assertion that the price elasticity with respect to the net cost of contributing is greater for high-income individuals than it is for low-income individuals.[10]

The thrust of the specific differential elasticities that we have estimated would suggest that the effect on contributions of the $200 million revenue loss from the present treatment of gifts of appreciated property would be about $200 million more contributions.[11]

Section 4: Since total contributions to charity must now be running in the vicinity of $20 billion, the outright repeal of a provision that induces contributions of $200 million would imply only a 1 percent drop in the level of contributions, a quite insignificant figure. This would seem to be a small price to pay for the elimination of a gross inequity and one that would have positive advantages for the charitable community as a whole since it would strengthen the institution of tax deductibility of contributions by removing its most ethically indefensible feature.

Outright repeal, however, would involve more than a 1 percent decline in the level of contributions for charities that depend relatively heavily on the contributions of wealthy contributors. In a special tabulation of income tax returns for 1962 it was found that about 3.6 percent of contributions of individuals deducted on income tax returns went to educational institutions. But the educational share was 16.8 percent for tax returns with AGI over $50,000 (in 1962 dollars).[12] If we assume that 85 percent of the impact of repealing the present law tax advantage for gifts of appreciated property falls above the income level of $50,000 (in 1962 dollars), then the possible impact on the contributions receipts of educational organizations might be a 4 percent decline in their contributions receipts from individuals.

Section 5: Although we are not impressed that these declines in contributions are catastrophic, we would recognize that they would generate a strong political opposition to repeal of the present favorable treatment of gifts of appreciated property.[13] This assessment of the situation leads us to search for a more acceptable supplement to the charitable contribution deduction than the present law favoritism toward gifts of appreciated property. What is needed for our supplement is a plan for making the contribution deduction more generous to offset the generosity involved in appreciated property transfers.

Section 6: Our proposed alternative is that taxpayers should be permitted to take more than a dollar deduction for each dollar contributed in excess of some percentage of their adjusted gross income.

This approach has some similarity to the present favorable treatment of gifts of appreciated property in that it involves an extra tax benefit for a particular kind of contribution. This variation has several attractive features:

1. The opportunity to take advantage of the extra bonus on the contributions deduction is not limited to taxpayers owning negotiable assets; rather the bonus is connected with making a relatively substantial effort on behalf of charity.

2. This basis of providing an extra deduction which is related only to effort relative to income increases the opportunity for low- and middle-income taxpayers to participate.

3. Relating the extra bonus only to marginal contributions over a base amount provides an especially effective incentive which works like a quantity discount in contrast to random price cuts.

Our proposed alternative admits of two areas where the specific numbers can be manipulated, the percentage of AGI beyond which the bonus will come in to play and the size of the bonus. Table 3 presents our calculations based on the 1968 distribution of contributions by size. As can be seen, as we move toward defining the contributions eligible for the premium as those over a smaller percentage of AGI, a larger share of the premium goes to lower-bracket taxpayers. We have also added an estimate of the marginal tax rate which is on average applicable in each bracket. This was derived by ordering taxpayers in each bracket from the highest marginal rate to the lowest and selecting the middle taxpayer. In the brackets from $50,000 to $500,000 we have made an arbitrary downward adjustment (shown in parentheses) for the 50 percent rate limitation on earned income.

Table 3
Distribution of Contributions in Excess of Various Percentages of AGI, 1966

AGI Class (in thousands)	Contributions in Excess of: 10% AGI (1)	8% AGI (2) (in millions)	6% AGI (3)	Average Marginal Tax Rate (4)
Under $5	$121	$154	$234	16%
$5-10	134	236	300	18
$10-15	64	151	271	22
$15-20	39	74	136	25
$20-25	29	44	73	26
$25-30	19	27	43	28
$30-50	68	94	132	39
$50-100	122	150	205	50 (45)
$100-200	134	151	187	60 (55)
$200-500	145	170	190	64 (57)
$500-1,000	93	106	110	68
Over 1,000	205	220	237	65

In Table 4 we have offered an estimate of the revenue loss, at 1968 income levels, from the failure to tax appreciation on property contributed to charity. This is based on the data for 1966 on non-cash contributions. We have assumed that an increasing portion of this is appreciated property as we go up the income scale. We have also assumed some marginal capital gains tax rates which were reduced by 10 percent to allow for some cases of appreciated property that would not otherwise have been sold.[14]

Table 5 compares the present law tax treatment of gifts of appreciated property with a 5 percent extra credit for contributions over 6 percent of AGI. We rejected a premium 10 percent deduction because this produced a distribution of benefits heavily weighted toward upper income brackets and not much different from the present law pattern. When the extra allowance is provided as a 5 percent credit, the revenue loss is comparable to the present law loss, but the benefits are significantly redistributed toward the lower brackets.

If the only factor that makes the non-imputation of gain on appreciated property contributions a relatively effective contribution incentive is concentration among upper-bracket taxpayers, we would have to concede that merely because the proposed alternative is less biased toward upper brackets it is less effective in inducing contributions per dollar of revenue lost. We think, however, that there is an extra fillip connected with the alternative related to the fact that it involves a high rate of deduction on the marginal contribution.

The precise evaluation of this effect does not seem feasible at this time but we can offer some judgements. To clarify the point at isssue we start with a highly simplified example. Let us assume a typical consumption good for which the elasticity of demand is minus one. This implies that a consumer who would have bought two units when the price was $1 per unit would buy four units when the per-unit price is cut to $0.50.

The problem suggested by our substitute contribution incentive is the following: how will the individual respond if the price of the item is restated as "$1 per unit for the first two and $0.50 per unit for the rest"? This is not an easy question to answer. If the individual thinks of all of his purchases of the item as a unit, then

Table 4
Estimate of Revenue Loss by AGI Brackets from Non-Taxation of Gain on Gifts of Appreciated Property
(1966 levels, present tax law)

AGI Class (in thousands)	Non-Cash Contri-butions (in millions)	Appreciated Property Contributions		Capital Gains Tax Savings	
		Percent of Non-Cash Contri-butions	Amount (in millions)	Percent of Appreciated Property Contri-butions	Amount (in millions)
	(1)	(2)	(3)	(4)	(5)
Under $5	$ 6	10%	$ 1	3.0%	$ -
$5-10	40	15	6	6.5	.4
$10-15	56	30	17	5.4	.9
$15-20	65	30	20	6.3	1.3
$20-25	35	40	14	7.3	1.0
$25-30	31	50	15	8.1	1.1
$30-50	66	70	46	9.9	4.6
$50-100	114	90	103	11.2	11.5
$100-200	141	92	130	11.7	15.2
$200-500	166	95	158	12.5	19.7
$500 Up	319	96	305	14.6	44.6
	$996		$817		$99.7

Notes:
Col (1) 1966 contributions multiplied in each class by percent non-cash 1966.
Col (2) Author's estimate.
Col (3) Col (1) times Col (2).
Col (4) Assumes that 90 percent of gains on appreciated property would have been realized in sale if not contributed. Thus, about 90 percent of 50 percent of marginal tax rate (Table 2) adjusted for the 25 percent alternative capital gains rate on $50,000 of gain where appropriate.
Col (5) Col (3) times Col (4).

he should not increase his purchases as much when the price is cut to "two for $2 and $0.50 apiece for the rest." In this case he would recognize that the price of four has only been cut from $4 to $3.

It is plausible, however, that one would think of his purchases separately. For example, the item in question is butter. I might buy two pounds at $1 per pound to use as food. If I could buy it at $0.50 per pound I would also cook with it, and then I would buy four pounds. If I am now faced with a price of $2 for two and $3 for four, it would be perfectly rational to increase my purchases exactly as much as I would have if the new price were a straight reduction to $0.50 a pound. I am not going to eat more butter because it has too many calories. If I can buy cooking butter at $0.50 a pound, I will cook with two pounds of it.

The substitute tax credit for "excess" contributions that we have proposed is quite like a quantity discount on butter. It is conceivable that individuals plan their contributions for the year as a whole, in which case a reduction in cost of 10 percent on half of the contribution would have the same effect as a reduction in cost of 5 percent on all the contribution. (An added tax deduction or credit is really a reduction in the net cost of the contribution to the contributor.) Alternatively, the contributor may be like our butter-lover. He may feel that with ordinary

Table 5

Estimate of Revenue Loss by AGI Bracket From a 5 Percent Extra Tax Credit for Contributions over 6 Percent of AGI, Compared With Non-Imputation of Gain on Appreciated Property Contributions

AGI Class (in thousands)	Revenue Loss From 5% Extra Tax Credit on Contributions Over 6% of AGI		Revenue Loss From Non-Imputation of Capital Gain on Appreciated Property Contributions	
	Amount (in millions) (1)	Percent of Total (2)	Amount (in millions) (3)	Percent of Total (4)
Under $5	$ 10.5	10.5%	$ -	0.4%
$5-10	17.9	17.8	0.4	0.4
$10-15	12.0	12.0	0.9	0.9
$15-20	6.1	6.1	1.3	1.3
$20-25	3.2	3.2	1.0	1.0
$25-30	1.9	1.9	1.1	1.1
$30-50	6.0	6.0	4.8	4.8
$50-100	9.2	9.2	11.5	11.5
$100-200	8.4	8.4	15.2	15.2
$200-500	8.9	8.9	18.7	18.8
$500 Up	16.0	16.0	44.8	45.0
	$100.1	100.0	$99.7	100.0

Source: Tables 3 and 4. Col (1) above assumes the same $100 million revenue loss as in Col (3). The distribution of the loss is based on the distribution of contributions over 6 percent of AGI as shown in Col (3) of Table 3.

deductibility, he wants to make some basic contribution to his church and community fund (like 6 percent of AGI). Contributions above that might be to groups for which he does not feel the same responsibility, like the starving in Bangladesh or victims of muscular dystrophy. If he thinks of these extra contributions as distinct from his basic contributions, then the marginal tax credit would have the same effect on his total contributions as if the marginal rate applied to all his contributions.[15]

In Table 6 we offer some estimates of the effect on contributions of the present law treatment of contributions of appreciated property and our proposed substitute in the form of a 5 percent extra tax credit for contributions in excess of 6 percent of AGI. The effect of the substitute is computed in two ways: one is on the assumption that the taxpayer decides on his total level of contributions at once; the other is on the assumption that the decision on marginal contributions is completely separate, that is, as in the cooking butter case, the cost reduction on the marginal contributions has the same effect as if it had applied to all contributions.

All of this is speculative, but we think that it is valuable for a general order of magnitude. First, to deal with the effect of non-imputation on contributions, we start with the elasticities estimated earlier by Brannon, and we take into account that non-imputation is a benefit over and above deduction. Thus, for example, when a contribution of property results in a deduction against a 50 percent tax, the cost to the donor is already down to 50 cents on the dollar and another 10 cents benefit on non-imputation is a 20 percent reduction of cost. These computations carried out with the basic elasticity estimates are shown in Part I of Table 6. The result is a staggering estimate that non-imputation generates three times as much in contributions as it costs in revenue.

Table 6

Estimated Effect on the Level of Contributions of Non-Imputation of Capital Gains Contributions of Appreciated Property Compared with Minimum and Maximum Estimates of a 5 Percent Extra Tax Credit for Contributions Over 6 Percent of AGI (1966 Levels)

I. Non-Imputation

AGI Class (in thousands)	Appreciated Property Contributions (in millions) (1)	Net Cost per Dollar Contributed (2)	Capital Gains Tax Savings (50% Appreciation) per dollar (3)	Proportionate Price Reduction Due to CG Saving (4)	Change in Contributions (in millions) (5)
Under $5	$ 1	$0.90	$0.030	0.0333	$ *
$5-10	8	0.82	0.045	0.055	0.1
$10-15	17	0.78	0.054	0.069	0.8
$15-20	20	0.75	0.063	0.084	1.5
$20-25	14	0.72	0.072	0.100	1.4
$25-30	15	0.68	0.081	0.119	1.6
$30-50	53	0.61	0.090	0.148	7.1-7.4
$50-100	103	0.50	0.112	0.224	21-22
$100-200	130	0.40	0.117	0.293	34-41
$200-500	153	0.36	0.122	0.339	47-61
$500 up	303	0.36	0.148	0.411	122-147
Total	$ 817				$227-284

II. Marginal Tax Credit - Minimum Estimate

AGI Class (in thousands)	Contribution Over 6% AGI (in millions) (1)	Net Cost per Dollar Contributed (2)	Not Applicable (3)	Proportionate Price Reduction from 5% Extra Credit (4)	Change in Contributions (in millions) (5)
Under $5	$ 234	$0.90		0.055	$ 4
$5-10	398	0.82		0.061	6
$10-15	271	0.78		0.064	12
$15-20	135	0.75		0.067	8
$20-25	71	0.72		0.069	5
$25-30	43	0.68		0.074	3
$30-50	133	0.61		0.082	10
$50-100	205	0.50		0.100	18
$100-200	187	0.40		0.125	21
$200-500	198	0.36		0.139	25
$500 up	355	0.36		0.139	44
Total	$2,230				$156

III. Marginal Tax Credit - Maximum Estimate

AGI Class (in thousands)	Contributions of Those Contributing Over 6% AGI (in millions) (1)	Net Cost per Dollar Contributed (2)	Not Applicable (3)	Proportionate Price Reduction from 5% Extra Credit (4)	Change in Contributions (in millions) (5)
Under $5	$ 532	$0.90		0.055	$ 8
$5-10	1,043	0.82		0.061	16
$10-15	746	0.78		0.064	32
$15-20	376	0.75		0.067	23
$20-25	177	0.72		0.069	12
$25-30	103	0.68		0.074	7
$30-50	288	0.61		0.082	21
$50-100	352	0.50		0.100	32
$100-200	306	0.40		0.125	34
$200-500	289	0.36		0.139	36
$500 up	459	0.36		0.139	57
Total	$4,671				$278

Table 6 (Cont'd)

NOTES - Table 6

Part I - Non-Imputation (present law)

Col. (1) From Table 4 (col (3))
Col. (2) From Table 3 (one minus col. 4)
Col. (3) From Table 4 (col (4))
Col. (4) Col. (3)/col. (2)
Col. (5) Change in contribution obtained by multiplying the base (col. (1)) by the price change (col. (4)) by the price elasticity of contributions. Here and in Parts II and III, these were taken as

Under 5	0.28	20-25	0.90	100-200	1.08-0.90
5-10	0.26	25-30	0.87	200-500	1.17-0.90
10-15	0.68	30-50	0.94-0.90	500 up	1.18-0.90
15-20	0.91	50-100	0.97-0.90		

Taken from Brannon "Effect of Tax Deductibility etc." op. cit., p. 10. The alternative lower figure above $30,000 is obtained by assuming that the actual high contributions in these brackets is explained by applying a lower elasticity to a marginal contribution decision.

Part II - Marginal Tax Credit - minimum estimate
Col. (1) From Table 3 (col. 3)
Col. (2) From Table 3 (one minus col. 4)
Col. (4) The credit rate 0.05 divided by col. (2)
Col. (5) As above, the base times the price change times the elasticity. In this case a marginal contribution decision process is assumed to apply to the contributions in excess of 6% of AGI. In the brackets above $30,000 the lower elasticity is used and in all brackets the price reduction effect of the credit is expressed as the price of contributions with deduction and credit compared to the price with deduction alone.

Part III - Marginal Tax Credit - Maximum estimate
Col. (1) From SOI, Individuals 1969
Col. (4) The credit rate 0.5 divided by col. (2)
Col. (5) Col. (1) times col (4) times the same elasticities used for the minimum estimate. The difference from the minimum estimate is that the incentive rate is assumed to apply to all contributions.

There is a logical problem in this result associated with the fact that in the original estimate of elasticity we took account only of ordinary deductibility but not the extra benefit of non-imputation, thus our basic estimate of elasticity is too high. We need a sort of two-stage estimate which is estimated very roughly in the note to col. 5. This reduces the estimate of the contributions effect of non-imputation to about two times the revenue loss.[16]

For the 5 percent extra credit, Parts II and III provide a minimum and maximum estimate (using the lower "two stage" elasticity estimate in each case). The minimum is one and one-half times the revenue loss and the maximum is three times. All we can say is that it is plausible that the extra credit would be nearly as effective in inducing contributions as non-imputation.

Conclusion

Gain should be imputed to contributors of appreciated property. For reasons developed in my essay with Strnad for the Filer Commission, I would not be concerned if this imputation reduced contributions to charitable activities. There are better ways for government to subsidize these things.

Past experience suggests that the political clout of philanthropies and wealthy contributors have blocked repeal of this patently unfair provision of present law. We think an extra credit proposal for contributions in excess of 6 percent of AGI is viable.[17]

Footnotes

1. There are some exceptions to this generosity toward contributors, such as certain gifts to foundations and gifts of property which would, on sale, give rise to ordinary income.

2. Terminology in the tax-reform literature is in bad shape. In popular writing, the provisions we are discussing would be called a loophole. That term implies that the legislators didn't know that the law provided this benefit. Plausibly, the term "loophole" was originally appropriate for appreciated property contributions because the abuse was in the absence of imputation, and the whole business of imputation is difficult for the congressional intellect. By 1869 the Congress clearly recognized that the law did not provide for consistent accounting for this kind of a contribution; and Congress intended this preferred treatment.

3. Assuming that appreciation occurs in one year does not change the problem in any way. An excess of value over basis implies that value exceeds the unrecovered cost. We could construct our example to cover several years, along with all the other intervening income, but the extra arithmetic would involve no different principle.

4. R. Barlow, H. Brazer, and J. Morgan, *Economic Behavior of the Affluent* (Washington, D.C.: Brookings Institute, 1966), p. 106.

5. For a general discussion of the problem of favorable treatment of the contributions of the rich under a system of deductions for charitable contributions, see Paul McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction," paper prepared for the Commission on Private Philanthropy and Public Needs, 1975.

6. This effect is discussed further in a paper submitted to the Commission on Private Philanthropy and Public Needs by Gerard M. Brannon and James Strnad, "Alternative Approaches to Encouraging Philanthropic Activities," 1975.

7. Note, for example, the tabulation of a survey of donor opinion reported by T. Willard Hunter, *The Tax Climate for Philanthropy* (Washington, D.C.: American College Public Relations Association, 1968), p. 118.

8. In 1966, $750 million of non-cash property was contributed. Plausibly, some of this was used property with market below basis. If 80 percent of this was appreciated property with 50 percent appreciation, the capital gains tax foregone would on average have been $75 million. At current levels this could be $200 million. The appropriate measure of revenue loss is the capital gains tax foregone since the donor could sell the asset to charity and donate the cash proceeds before tax, leaving himself in the same position as if he had donated the property and paid the tax (assuming the sale price is the same as the tax valuation of the property).

9. The proportion between revenue loss and contributions effect assumed here is the one estimated by G. Brannon in "The Effect of Tax Deductibility on the Level of Charitable Contributions and Variations on the Theme" (Washington, D.C.: Fund for Public Policy Research, 1974).

10. See Ibid. The same result, with somewhat greater elasticities, is reached by Martin Feldstein in his paper prepared for the Commission on Private Philanthropy and Public Needs. This pattern of high incomes being more responsive is also found by C. Harry Kahn in *Personal Deductions In The Federal Income Tax* (Princeton, N.J.: Princeton University Press for the National Bureau of Economic Research, 1960) and by Michael Taussig in "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," *National Tax Journal*, 20:1 (March 1967). Taussig puts both elasticities at very low levels. It is interesting that exactly the opposite result is reached by Robert Schwartz in "Personal Philanthropic Contributions," *Journal of Political Economy* (1968), pp. 1204-91.

11. G. Brannon, "The Effect of Tax Deductibility," op. cit., p. 23.

12. Based on data from *Statistics of Income Individuals*, 1962, Internal Revenue Service (Washington, D.C.: Government Printing Office).

13. In the debates of the Ways and Means Committee leading to the Tax Reform Act of 1969, there was consideration of outright elimination of the favored treatment of gifts of appreciated property. Political opposition to this change led to the compromise solution that imputation of gain be limited to some highly selective gift situations.

14. Note Brannon, "The Effect of Tax Deductibility," op. cit., p. 21.

15. In technical economic terms, the income effects of these alternatives differ, but we regard this difference as minimal.

16. This is an appreciably higher estimate of contributions effect than Brannon estimated in "The Effect of Tax Deductibility," op. cit. The present technique gives greater emphasis to the marginal effect of non-imputation which comes on top of a very fat deduction, in some cases reducing the net cost of contributing to near zero.

17. We assume that various proposals before the Commission, such as a possible floor for deductible contributions, involve an annual ratio of contributions to income. This may be subject to considerable manipulation by lumping contributions in alternate years. I have not studied the lumping problem here, but assumed that it would be studied by the Commission. If this annual bunching is a significant problem, then the formula for extra credit could be designed on the basis of contributions over 6 percent on a two-year average.

Part III

Volunteer Services

TREATMENT OF VOLUNTEER SERVICES AND RELATED EXPENSES UNDER THE INTERNAL REVENUE CODE

Edmund C. Bennett†

Section 170 of the Internal Revenue Code states as a general rule that "[t]here shall be allowed as a deduction any charitable contribution . . . payment of which is made during the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate."[1] Section 170(c) defines a charitable contribution as being "a contribution or gift to or for the use of" a state, but only if the contribution is made for exclusively public purposes; a corporation, trust, or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; a post or organization of war veterans; a qualified fraternal society; and a qualified cemetery company.[2] It is firmly established that this section of the Code contemplates a contribution of money or property but not of services.[3] No deduction is allowed for the contribution of services, but several regulations provide that unreimbursed expenditures incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution.[4]

I

HISTORY OF THE RULE

The historical and legislative foundations for the rule that no deduction is allowable for the contribution of a taxpayer's services to charity are not certain. The language of the Code itself that there "shall be allowed as a deduction any charitable contribution" seems to encompass much more than the money or property but not services delineation made in the regulations. Congress has never clearly said that section 170(c), which allows a deduction for a contribution to or for the use of certain organizations, is restricted to the transfer of property or money.[5] Since 1920, however, the Treasury Department has ruled consistently that there was no deduction available for the value of services rendered to charity. Even though the statute is not restricted on its face to money or property, a number of factors have combined to prevent any declaration that section 170(c) includes the contribution of services:[6]

1. In addition to the initial 1920 ruling,[7] other revenue rulings have held that free newspaper space donated to a charity was equivalent to a service and thus not deductible,[8] and that the donation of blood was nondeductible because it constituted the contribution of a service.[9]

2. Besides the two existing regulations which state that there is no deduction for the contribution of services to charity,[10] there was an earlier regulation which provided that the basis for a charitable gift other than money would be the fair market value of the *property* at the time of the contribution or gift.[11] This regulation was relied upon in the revenue ruling that held that the furnishing of blood to a blood bank was analogous to the rendering of a personal service, rather than a contribution of property, and thus not deductible as a charitable contribution.[12]

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3. The tax court once avoided the issue as to whether a deduction is available for the contribution of legal services. In *Joseph P. Monaghan*,[13] the court was confronted with the claim by a lawyer and his wife that they were entitled to a deduction for the value of the legal services performed for their church. The tax court avoided the issue and ruled that even if the value of legal services in such circumstances was deductible, the deduction sought had to be disallowed for a failure of proof. In *J.R. Holmes*, however, the tax court recognized the existence of the doctrine while holding that the value of two films donated to charity was deductible as a donation of property.[14]

4. Another concept which has maintained the vitality of the no deduction for services rule is the reenactment doctrine. The crux of this doctrine is that "Treasury Regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law."[15]

5. Judicial decisions have also perpetuated the rule. A claim for depreciation expense on a car used for charitable purposes was denied in the *Orr* decision in part because "[a] depreciation expense . . . is not a 'payment', not a transfer of money or property."[16] The court of appeals also noted that "'payment' is an essential part of the definition of charitable contribution in section 170(c)."[17]

6. Congressional statements also support the rule. Although no clear or definitive guidelines can be extracted from the legislative history of the provisions for charitable deductions, there are repeated statements concerning wealth, money, property, amounts, and payments indicating that the deduction was intended for tangible contributions of money and property.[18]

These factors – the longstanding revenue rulings, the regulations, the tax court position, the reenactment doctrine, persuasive case authority, and congressional statements – combine to prevent any judicial declaration that section 170(c) includes the contribution of services.[19]

II

THE DISTINCTION BETWEEN PROPERTY AND SERVICES

A wide variety of donated activities have been held to be equivalent to services and thus not to constitute charitable contributions. For instance, the publication of a scientific article written by the taxpayer does not constitute a charitable contribution,[20] nor does the claimed value of scientific articles that he contributed through certain scientific organizations for printing in their publications.[21] The furnishing of blood to a blood bank has been held to be analogous to the rendering of personal service.[22] A newspaper donating space is rendering a service and not making a gift of property.[23] Similarly, a radio station providing free air-time is not entitled to a deduction,[24] and a carpenter who donated his time to a county civil defense organization to build observation posts could not deduct the value of such time as a contribution.[25] The cost of research work in connection with trade relations between the United States and Hungary amounted to a nondeductible service, and there was also no showing that the work benefited a charitable organization.[26]

The distinction between property and services, however, is not easily drawn. A number of decisions serve to point out the difficulty in making this distinction. The general manager of a television station who also operated an independent film production business donated two of his successful films to two charities. The Commissioner unsucessfully maintained that the gifts were in the nature of services, rather than property. The court held that long before the time of each donation, the manager's services had coalesced with the unprocessed film in the same way that an artist adds value to a canvas by painting works of art. Furthermore, each production was a tangible commodity which could be physically owned or possessed.[27] Similarly, two essays prepared by an economist and donated to a qualified charitable organization were held to be property, rather than services. Artistic property that the economist had created was, in fact, donated to charity. The value for deduction purposes was $500.[28]

These two examples show that the distinction between property and services is often blurred. It will be necessary to make this differentiation so long as the present matrix exists in which that distinction is deemed determinative of tax liability. Since the regulations create the distinction between contributions of property and contributions of services, that distinction must be applied to the facts of a case even if such application requires strained definitions.[29]

If a charitable contribution is "in property other than money," the regulations state that "the amount of the deduction is determined by the fair market value of the property at the time of the contribution. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relative facts."[30] It is possible to establish a fair value for most kinds of property in this manner; however, there are practical difficulties in measuring the value of services contributed to a charitable organization. The basis for the position that no deduction is allowable for the contribution of services appears to be the tax administration problems involved in verifying and measuring the fair market value of personal service donations. In addition, the disparity in the value of personal services among taxpayers, as well as the question of whether or not the donor has actually parted with anything when he donates his personal services, provide more foundation for this position.[31] There are too many practical difficulties in value measurement in circumstances where our market economy provides no ascertainable price, and this serves to prohibit a tax deduction for services contributed to charity.[32] In a footnote in the *Holmes* decision the tax court noted that the case law supporting the distinction between donations of services and donations of property is meager;[33] however, as already discussed, this doctrine is very well entrenched, and any judicial declaration that section 170(c) includes the contribution of services is unlikely.[34]

Criteria To Be Used in Making the Distinction

It is clear that how one differentiates between property and services is critical in determining whether or not one is entitled to a deduction for a contribution. In the *Holmes* case the tax court went to the dictionary for assistance. Property is variously defined as "something that is or may be owned or possessed," "the exclusive right to possess, enjoy, and dispose of a thing," and "something to which a person has a legal title," while services are variously defined as acts "done for the benefit or at the command of another," actions "that further some end or purpose," conduct "that assists or benefits someone or something," and "deeds useful or instrumental to some object."[35] Thus, the notion of physical ownership provides one significant measure for distinguishing between property and services. Property is something that may be physically owned or possessed, while services, because of their inherently ephemeral nature, are incapble of being so held.[36]

In the *Holmes* decision, the tax court applied the dictionary definition to a factual situation involving an independent film producer who had donated two films of his own production to certain qualified charities and claimed a deduction. The Commissioner contended that the donations did not qualify because they were in the nature of services rather than property, but the tax court held to the contrary. The court said that it could not be denied that the taxpayer applied his talents to transform the unprocessed film into the productions but that long before the time of each donation, his services had coalesced with the film to form something different from both his services and the unprocessed film. He added value to the film in the same way an artist adds value to canvas by painting works of art, that a cartoonist adds value to paper by drawing cartoons, or that a farmer adds value to crops or cattle by applying the skills of husbandry. Each film was a tangible commodity which could be owned or possessed. The taxpayer did in fact own each film, and until the ultimate moment of donation each film remained in his possession. When he made the donations, each donation was a donation of his ownership in a film production and that ownership had a value separate from the services that went into production.[37]

The court seemed to reach its conclusion without much difficulty, but it admitted that in distinguishing between property and services it had merely shifted the controversy to a different definitional level. Thus, the distinction it made placed importance upon the notion of physical ownership, but it questioned how the terms "physical" and "ownership" were to be defined upon further analysis.[38]

The court also indicated that this dictionary-definition guideline did not conflict with the rationale underlying the denial of a deduction for the contribution of services. One reason for that denial was the administrative difficulties attendant upon the valuation of services, but where what is to be valued is something tangible, such as a film production, the fact that the production is donated by its producer rather than by a nonproducer should not drastically affect the valuation process. Second, the argument that artists and craftsmen are in a better position than the rest of the populace to take advantage of the provisions of section 170 was dismissed by the court as providing no more reason to deny them deductions for contributions of their own creations than would a similar argument denying charitable deductions to the rich on the ground that they are in a better financial position than the poor to take advantage of the provisions of that section.[39]

The *Holmes* decision was followed in *Bernard Goss*[40] which held that a taxpayer was entitled to a deduction for his donation to charity of two essays of his own creation. The donation of the essays constituted a contribution of property and not of services. The tax court said that the petitioner donated artistic properties he himself had created, the completed manuscript being something different from his services and the blank paper. He had maintained physical ownership over the property before it was donated, and accordingly, the court concluded that the donation of the artistic property, an essay, constituted a donation of property rather than of services.[41]

In spite of its conclusion that the essays constituted property, the court's method of calculating the value of these essays was not made clear. The taxpayer valued them at $2,250. This figure was derived from his charge of $150 per day as a consulting fee times the 15 days that he worked on the essays. The court was not able to accept this argument and found his testimony that the essays would have produced a bid of between $10,000 and $20,000 if they had been contracted for in the open market to be self-serving. It arbitrarily determined that the essays had a value of $500.[42] On the other hand, in the *Holmes* case the court accepted the taxpayer's testimony that a willing buyer would have paid $100 per minute for his two films. This was the price at which he customarily sold film of the type he donated and the fair market of the films were $1,500 and $3,000, respectively.[43]

Factors Limiting the Effectiveness of the Criteria

The dictionary-definition method of differentiating between what constitutes property and what constitutes services seems workable, but one must often stretch these definitions in order to encompass a certain factual situation within the matrix. Such semantical stretching, however, leads to distinctions that are borderline, mere judgment calls, or even irrational. For instance, it does not seem rational to say that a person's blood is not something that is phyiscally owned or possessed, but a ruling held that the furnishing of blood to a blood bank is analogous to the rendering of a personal service and not deductible.[44] A special ruling held that a carpenter who donated his time to a county civil defense organization to build observation posts could not deduct the value of such time as a contribution.[45] On the other hand, suppose that the carpenter constructed something which he then later donated to the civil defense organization. With his talents he added value to the lumber in the same way that an artist adds value to canvas by painting a work of art. The entity he built remained in his possession until the time he donated it to the charitable organization; and when he made that donation, it was a donation of his ownership in the constructed object. It seems reasonable to say that the ownership of the object had a value separate from the services which went into its construction. Therefore, the carpenter should receive a deduction for donating this object to charity. It does not make much sense that the availability of the deduction would turn on factors such as where and when the carpenter used his skills. With borderline situations such as these, there does not seem to be any workable and understandable method for differentiating between what constitutes the contribution of a service and what constitutes the contribution of property. In addition, the arbitrary valuation of the essays in the *Goss* case points out another shortcoming of the dictionary-definition method of making the distinction between property and services. In close cases, valuation of the "property" donated is difficult and far from accurate. The problem involved in such valuation was and is the primary reason why no deduction has been allowed for the contribution of services to charity.

III

AVAILABILITY OF A DEDUCTION FOR EXPENDITURES

Even though no deduction is allowable for a contribution of services, the regulations say that unreimbursed expenditures may constitute a deductible contribution, if such expenditures were made incident to the rendition of services to an organization that qualifies as a charity. The regulations provide the example that the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible, as are reasonable expenditures for meals and lodging necessarily incurrred while away from home in the course of performing donated services.[46]

The Rule in General

Initially, expenses incurred in connection with the donation of services to a charity were not deductible. A 1924 ruling under the Revenue Act of 1921 held that the expenses of a delegate to a church conference or to an American Legion convention paid by himself were not charitable contributions but personal expenses and not deductible.[47] That ruling provided no further explanation for its conclusion, and its position was reversed in a ruling that unreimbursed expenses of a delegate to a church convention or an American Legion convention may qualify as charitable contributions.[48] The unreimbursed expenses have to be directly connected with and solely attributable to the rendition of volunteer services by the taxpayer to the church or to the American Legion to constitute deductible contributions. This ruling, which revoked the 1924 ruling, was based on a series of rulings handed down in the mid-1950s which held that unreimbursed traveling expenses, including the cost of meals and lodging and other out-of-pocket expenses, incurred while rendering volunteer services for charitable organizations qualifying under section 170(c) of the Code constituted contributions or gifts within the meaning of the Code.

The basis for the position that unreimbursed expenses incurred in connection with the rendition of services for a charitable organization are deductible is section 170(c). This section states that "the term 'charitable contribution' means a contribution or gift *to or for the use of"* a variety of charitable organizations. An expense incurred in connection with rendition of a personal service for a charity is a payment to or for the use of the charity. For example, it has been held that an individual who uses his plane and automobile part of the time in connection with his lay religious activities in the church was not entitled to a charitable contribution deduction for an allocable portion of depreciation, insurance, and repairs since such items did not represent payments made "to and for the use of" the church.[49] The taxpayer was entitled to deduct for "out-of-pocket transportation expenses necessarily incurred in rendering donated services" to the church. The court found, however, that the depreciation of the car, even though the car had been put to the use of the charity, did not constitute a payment and that the taxpayer's insurance expense could not be deducted because it was a personal expense, in addition to the fact that it benefited the insured and not the church. Similarly, the repairs were for the benefit of the owner and could not constitute payments within the meaning of the statute. The court added that if the repairs had been performed upon an automobile that was used exclusively for the purposes of the charity then the payment for such repairs would have constituted payment for the use of the charity. The taxpayer, however, had used the vehicles only in part for charitable purposes, and thus the repairs could not be attributable to the partial charitable use.[50] In affirming this part of the decision, the court of appeals said that the taxpayer had not proved that the repairs were caused by the use of the vehicles for the charitable purposes and that he had the burden of proof on this matter. His failure to prove that the charitable use caused the repairs barred his claim for the charitable deduction.[51]

The Service has ruled that expenses incurred by persons attending church conventions solely as members of the church, rather than as duly chosen representatives, are not deductible as charitable contributions, notwithstanding the fact that such attendance is required or expected of them by the tenets of their particular religious group.[52] This rule, however, does not preclude the deduction, as a charitable contribution, of unreimbursed expenditures *directly* connected with and *solely attributable* to the rendition of gratuitous services performed for the church during the meeting.[53] Nor does the rule preclude the deduction of any unreimbursed expenses which a civil defense volunteer may incur in carrying out civil defense duties, such as necessary travel expenses for attendence at meetings, weapons tests and civil defense exercises, mailing costs, or other expenses. It is clear that where the expenditures made were clearly for "the use" and the benefit of a qualified public charity, deductions are allowable even though there was no passage of title or ownership of specific property.

Accordingly, expenditures made by a taxpayer for repairing and refurbishing a chapel located on an ancestoral estate owned by him, which had been used exclusively as a parish church, are deductible.[54] The Commissioner objected to the allowance of the claimed deductions on the ground that title to the land on which the chapel stood and ownership of the chapel building and its furnishings were in the name of the decedent. The Commissioner contended that any repairing and refurbishing with respect to the chapel was to the benefit of the taxpayer's realty and hence could not qualify as a contribution to the church. The court felt that this view was too narrow and that the issue could not be resolved solely on the basis of who owned title to the chapel property. It noted that the Code does not make specific reference to title or ownership of the premises on which the charitable activities are conducted, but rather places emphasis on the character of the charitable donee and on the nature of the activities for which the contribution is made. Thus, section 170(c) of the Code allows deductions in the case of an individual for contributions or gifts "to or for the use of" a qualified charitable organization for religious or charitable purposes.[55] All the work was done to enable the chapel to continue to function, to increase the comfort and safety of those members of the public who worship there, and to enhance the beauty and dignity of the religious setting. The work was not intended to be, and was not, for the taxpayer's own benefit nor was it intended to, nor did it, increase the value of his estate.[56]

A taxpayer who gives his services gratuitously to an association, contributions to which are deductible, and incurs unreimbursed traveling expenses, including the cost of meals and lodging, while away from home in connection with the affairs of the association and at its direction may deduct the amount of such unreimbursed expenses in computing his net income.[57] The Service has announced that with respect to all periods after December 31, 1969, six cents a mile is a reasonable rate at which to compute the cost of operating an automobile for transportation expenses deductible as a charitable contribution under section 170 of the Code.[58] Use of this standard mileage rate, however, is not mandatory, and where a taxpayer's allowable nonreimbursed transportation expenses for charitable purposes exceed this rate, the taxpayer may deduct such actual expenses.[59] Also deductible are expenses of a taxpayer for entertaining persons and making telephone calls in the course of rendering services to an exempt organization, but the portion of the entertainment cost allocable to the taxpayer himself may not be deducted.[60] Unreimbursable out-of-pocket expenses incurred directly in connection with the performance of official duties by mayors, councilmen, or other elected officials, who serve without compensation, also constitute charitable contributions.[61]

Factors To Be Considered

The primary factors warranting a deduction for expenditures and other out-of-pocket expenses incurred while rendering services to a charitable organization are (1) that the charity is the primary beneficiary of the service, (2) that the expenses are directly attributable to the performance of the service for the charity, (3) that the organization for which the services were rendered is one to which contributions are deductible, and (4) that for the cost of meals to be deductible, such meals must be taken while away from home (that is, away from home overnight) in the course of rendering volunteer services. For instance, the expense of travel to foreign countries on behalf of the People-to-People Program was not deductible since the taxpayer was the primary beneficiary of the travel.[62] In *Travis Smith*,[63] the taxpayer was held to be entitled to a charitable contribution deduction for the out-of-pocket expenses he incurred in carrying out evangelistic work for his church. None of the meals and laundry and camping expenses attributable to the taxpayer's children and certain other individuals were allowed since these expenses were not directly related to the taxpayer's service. Contributions made to committees organized to carry out the People-to-People Program and out-of-pocket expenses incurred by members in connection with the formation of and the rendering of volunteer services to such committees are deductible as charitable contributions, but the contributions must be made to committees certified by the United States Information Agency as being exclusively in furtherance of the program in order to be deductible.[64] Another taxpayer was not allowed to deduct the cost of meals as charitable contributions because such costs were seen as being personal living expenses since the taxpayer did not show that they were incurred while away from home.[65]

The Effectiveness of the Deduction

The problems involved in determining whether a deduction is allowed for an expense incurred while rendering a service to charity seem rather minor in comparison with the difficulties in distinguishing between property and services. What constitutes an expenditure or an out-of-pocket cost seems to be fairly well defined throughout the Code – business expenses, entertainment expenses, meals and lodging provided by an employer, traveling expenses, and so forth. Also, expenses can be handled with relative administrative ease because the values of most forms of expenses are readily ascertainable. The tests that must be passed for an expense to be deductible are unambiguous and workable: The charity has to be the primary beneficiary of the service for which the expense was incurred; the expense must be directly attributable to the performance of the service; the recipient of the service must be a qualified charitable organization; and meals must be consumed while away from home overnight for their costs to be deductible. All in all, there do not seem to be too many conceptual or administrative problems involved in allowing a deduction for expenses incurred while rendering services for a qualified charity.

Footnotes

1. Int. Rev. Code of 1954, § 170(a).

2. Ibid., § 170(c).

3. J. Mertens, *The Law of Federal Income Taxation*, § 31.05, at 51 (1969).

4. Reg. § 1.170-2(a)(2); ibid., § 1.170A-1(g). These regulations were apparently based on O.D. 712, 3 Cum. Bull. 188 (1920), which was declared obsolete though not specifically revoked or superseded, by Rev. Rul. 69-31, 1969 IRB-4, p. 23.

5. Baird, *Charitable Deductions for Pro Bono Publico Professional Services: An Updated Carrot and Stick Approach*, 50 Texas L. Rev. 441, 443 (1972).

6. Ibid.

7. O.D. 712, 3 Cum. Bull. 188 (1920).

8. Rev. Rul. 57-462, 1957-2 Cum. Bull. 157.

9. Rev. Rul. 162, 1953-2 Cum. Bull. 127.

10. See note 4 supra.

11. Regs. 111, § 29.23(o)-1 (emphasis added).

12. Rev. Rul. 162, 1953-2 Cum. Bull. 127.

13. 16 T.C.M. 159, 161 (1957).

14. *J.R. Holmes*, 57 T.C. 430 (1971).

15. *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938).

16. *Orr* v. *United States*, 343 F.2d 553, 556 (5th Cir. 1965).

17. Ibid.

18. See generally House Conf. Comm., H.R. Rep. No. 172, 65th Cong., 1st Sess. 32 (1917); House Comm. on Ways and Means, H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938).

19. Baird, supra note 5, at 444.

20. *William Fox*, 22 T.C.M. 1239 (1963); William Fox, 24 T.C.M. 1001 (1965).

21. *William Fox*, 24 T.C.M. 1001 (1965).

22. Rev. Rul. 162, 1953-2 Cum. Bull. 127.

23. Rev. Rul. 57-462, 1957-2 Cum. Bull. 157.

24. Rev. Rul. 67-236, 1967-2 Cum. Bull. 103.

25. Special Ruling, October 8, 1931, 525 CCH Ch. 6125.

26. *G. Kordu*, 30 T.C.M. 888 (1971).

27. *J.R. Holmes*, 57 T.C. 430 (1971).

28. *B. Goss*, 59 T.C. 594 (1973).

29. *J.R. Holmes*, 57 T.C. 430, 437 (1971).

30. Reg. § 1.170-1(c)(1).

31. Alvin, *Charitable Contributions: Fruit and Tree*, 118 J. of Accountancy 38, 39 (1964).

32. Commission on Private Philanthropy and Public Needs, *Philanthropy and the Federal Tax System* 14 (1973).

33. 57 T.C. at 435 n.3.

34. See text and notes at notes 6-19 supra.

35. 57 T.C. at 436 quoting Webster's New International Dictionary 1818, 2075 (3d ed. 1961).

36. 57 T.C. at 436.

37. Ibid., at 436-37.

38. Ibid. at 437 n.7.

39. Ibid. at 437 n.6.

40. 59 T.C. 594 (1973).

41. Ibid. at 596.

42. Ibid. at 597.

43. 57 T.C. 430, 439 (1971).

44. Rev. Rul. 162, 1953-2 Cum. Bull. 127.

45. Special Ruling, October 8, 1951, 525 CCH Ch. 6125.

46. Reg. § 1.170-2(a)(2).

47. I.T. 1988, III-1 Cum. Bull. 198 (1924).

48. Rev. Rul. 58-240, 1958-1 Cum. Bull. 141.

49. *Orr v. United States*, 226 F. Supp. 809 (M.D. Ala. 1963), *aff'd*, 343 F.2d 553 (5th Cir. 1965).

50. Ibid. at 811.

51. 343 F.2d at 558.

52. Rev. Rul. 61-46, 1961-1 Cum. Bull. 51.

53. Ibid. at 52.

54. *Estate of Philip A. Carroll*, 38 T.C. 868 (1962).

55. Ibid. at 873.

56. Ibid. at 875.

57. Reg. § 1.170-2(a)(2).

58. Rev. Proc. 70-24, 1970-2 Cum. Bull. 505.

59. Rev. Proc. 64-15, 1964-1 Cum. Bull. 576 (Part 1).

60. *Francois Louis*, 25 T.C.M. 1047 (1966).

61. Rev. Rul. 59-160, 1959-1 Cum. Bull. 59.

62. *Sheffels v. United States*, 264 F. Supp. 85 (E.D. Wash. 1967), *aff'd*, 405 F.2d 924 (9th Cir. 1969).

63. 60 T.C. 988 (1973).

64. Rev. Rul. 57-38, 1957-1 Cum. Bull. 96.

65. *C.H. Mitchell*, 42 T.C. 953 (1964).

Part IV

Estate and Gift Taxes

ESTATE TAX DEDUCTION FOR CHARITABLE BENEFITS: PROPOSED LIMITATIONS

John Holt Myers†

Introduction

Section 2055 of the Internal Revenue Code allows for federal estate tax purposes a deduction against the estate for the "amount of all bequests, legacies, devises or transfers" for qualified governmental, educational, scientific, literary, religious and other charitable purposes.[1] There is no limit on the charitable bequests out of the testator's taxable federal estate that may be deducted. If the decedent bequeaths his entire estate for proper charitable purposes, there is no federal estate tax payable.

Questions have been raised with respect to the propriety of the unlimited deduction, for federal estate tax purposes, of bequests or other testamentary transfers to charity. The proposal for change receiving the most attention is a suggestion that a percentage limitation of perhaps 50 percent of the taxable estate be imposed with respect to charitable bequests in computing the federal estate tax.[2] This is said to be similar to the present limitation on the deduction of charitable contributions for income tax purposes. In the alternative, it has been suggested that a deduction of no more than 50 percent of the estate should be allowed for bequests to private foundations. Finally, it has been suggested that only charitable bequests that exceed a floor, perhaps 5 percent of the estate, be deductible.

In weighing any such proposals, the Filer Commission should consider:

1. The amount by which the federal revenue would be increased or decreased by reason of any modification of the federal estate tax statutes.
2. The relative importance of charitable bequests and the effect that any change in the tax structure might have on the amount of funds flowing to the charities from this source.
3. The justification and purpose for the federal estate tax and their relationship to any proposed changes.

I

HISTORY AND PURPOSES OF ESTATE TAX DEDUCTION

With one exception, for 100 years our federal succession taxes have permitted an unlimited deduction for bequests or similar transfers for appropriate purposes.[3] In revoking that one exception by providing a refund of an earlier inheritance tax which had no exclusion for charitable bequests, the Ways and Means Committee in 1902 noted:

> In a word, these institutions embrace the whole domain of the charities of the country. It is inconceivable that it was ever intended by Congress to levy this enormous tax upon legacies for such uses and, in effect, to put a hand in the contribution boxes of the country. The vindication of our national character calls for the refunding of the moneys thus taken.[4]

In supporting the continuation of the charitable exemption in the Senate version of the Revenue Act of 1918, Senator Boyce Penrose, the ranking Republican on the Senate Finance Committee, expressed the rationale for exemption as follows:

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> Public institutions and charities have been hard hit by the war. In this country educational and charitable institutions carry on in a large measure what essentially is public work. That our educational and charitable institutions have been largely founded and maintained by individual gift and bequest has been widely commented upon by publicists in every land. In this respect we differ much from older countries where State appropriations have largely aided this work. That in the United States they have been built by private enterprise furnishes a peculiar illustration of the qualities in American civilization which have made our country great. Contributors to these institutions have been remarkably loyal but under war conditions and with the high rates of income tax they could hardly have been expected to have done as well as in times of peace. The provision of the committee inheritance tax amendment (to the House version) exempting from tax transfers to the government or for any religious, charitable, or scientific purpose is to be commended particularly.[5]

The essence of the justification for the exemption was that the funds passing for the public, charitable, and religious uses now described in IRC Section 2055 should not be burdened with a tax since those funds were destined to be used essentially for public purposes.

It should be noted that all of the states provide an unlimited charitable contribution deduction either directly in their inheritance tax or indirectly through the estate tax designed to utilize the federal credit. (In a few states there are limitations of one sort or another to charitable beneficiaries within the jurisdiction.) Any change in the federal estate tax statute is bound to be reflected in similar changes by the states. While in past years this would have been relatively unimportant because of the low rates, such changes could be significant in view of the substantial succession levies that are now being imposed in many jurisdictions.

In contemplating any changes in the federal estate tax statute, it is important to consider the purposes underlying its enactment. Although originally enacted as an emergency revenue measure, the estate tax has not been of major importance in terms of total gross revenue needs. For many years the receipts have averaged in the neighborhood of 2 percent or less of the total revenue collected.[6] Although it is apparently difficult to make definitive estimates, it would appear that $2.1 billion of charitable bequests deducted in the last year for which there is data (1970) against $25.7 billion in economic estates subject to a tax would have added less than $1 billion to the $3 billion of revenue from this source if the deduction had been denied *in full*.

It would appear that since 1935 the major purpose behind the federal estate tax has been to redistribute wealth. In that year, the tax first became steeply progressive with rates ranging from 2 to 70 percent. President Roosevelt, in urging the change as a vehicle for redistributing the national wealth in the public interest, said: "Great accumulations of wealth cannot be justified on the basis of personal and family security. . . A tax upon economic power is a tax upon static wealth, not upon that dynamic wealth which makes for the healthy diffusion of economic good."[7]

Combined with the gift tax which was enacted in 1932, the steeply progressive estate tax was clearly intended to operate as a means of effecting a redistribution of wealth which would otherwise be transmitted to private persons.

Importance of Bequests

Bequests have become an increasingly important source of support for charitable institutions. In 1963 they accounted for 8.3 percent of all charitable giving, increasing to 9.4 percent by 1966 and 11.5 percent by 1969. In 1972 testamentary giving totaled $2.73 billion or 12 percent of total charitable support.[8] By way of example, in 1970-1971, bequests accounted for nearly 18 percent of the some $1.8 billion of estimated contributions to colleges and universities.[9] It seems likely that a substantial portion of the endowments of major educational and charitable institutions are in fact traceable to bequests received over the years.

Firm figures are hard to come by, but qualified analysts using data for separate years have estimated that 70 percent of the total charitable bequests are from estates in which the bequest exceeded 50 percent of the decedent's gross estate and that the amount of charitable bequests in excess of 50 percent of an estate is equal to approximately 25 percent of the total charitable bequests.[10] This suggests that $400 to $700 million out of the estimated some $2.8 billion of charitable bequests reported on federal estate tax returns filed in 1974 represent bequests that were in excess of 50 percent of the decedent's total taxable estate.

It is also important to consider the kinds of institutions that are the recipients of bequests. Based upon studies for 1957 and 1959, organizations devoted to social welfare purposes received approximately 45 percent, educational organizations approximately 23 percent, and religious organizations some 14 percent, with the balance of 17 percent going to all other organizations. (See Appendix A, Table A.) This contrasts markedly with the distribution of contributions claimed against the federal income tax returns in the period 1961-1971, when religious organizations received 46 percent, educational and health organizations approximately 16 percent each, and social welfare and civic and cultural organizations 8 and 5 percent, respectively.[11]

The indirect support of charities through bequests to private foundations suggests a slightly different pattern, with educational organizations receiving approximately 38 percent of the grants, social welfare 23 percent, health 15 percent, the humanities 10 percent, and science and religion 7 percent each. (See Appendices B and C.)

While it is difficult to generalize from such studies, it seems fair to state that a substantial portion of all bequests—those made directly, or indirectly through private foundations—provide support for essential public services, especially education and social welfare.

The Deduction as an Incentive to Charitable Bequests

It is important to determine what role the federal estate tax deduction plays as an incentive to charitable bequests. Unfortunately, there is little, if any, information upon which to base a firm judgment. Much of the discussion as to the possible incentive effect of the federal estate tax charitable deduction is necessarily pure speculation. It is clear, however, that the charitable bequest as a percentage of the gross estate has steadily increased over the years since the enactment of the statute; by 1970 it had reached 7.2 percent. (See Appendix D, Table D-1.) As one analyst has suggested, the percentage increase is probably greater since many more small estates have filed federal estate tax returns in recent years (the charitable bequest is a relatively unimportant factor in small estates).[12] That the charitable bequest deduction is more significant in large estates would lead us to conclude that it does provide a substantial incentive. (See Appendix D, Table D-2.)

II

CRITICISMS AND EVALUATION OF ESTATE TAX DEDUCTION

Criticisms

The criticism of the present unlimited deduction against the federal estate tax for contributions to qualified charitable institutions may be divided into two general categories. The first might be termed visceral; it is based upon concepts of equity. The second is practical in the sense that it deals with the revenue implications.

Every estate should pay some tax. Whatever the appropriateness of such a contention with regard to income taxes, this doctrine is subject to serious challenge insofar as the charitable deduction for estate taxes is concerned. Assuming that the charitable beneficiaries are deserving of support because they serve public purposes (and the evidence supports the proposition that bequests, directly or indirectly, flow to institutions that provide or support services that would otherwise have to be provided by the government), then the charitable bequest, be it part or whole, can provide no benefit to the decedent. Nor can it provide any benefit to his legatees or heirs who would obviously be much better off with the net of any estate or portion thereof after taxes. Even in the case of a bequest to a private foundation, by reason of the changes made by the 1969 Tax Reform Act the bequest is slated to provide a service that is clearly public through the strictures imposed on the organization and operation of private foundations and the requirements of current and substantial distribution of funds. The doctrine might have some effect were any real benefit retained for private purposes. By reason of his death, the donor cannot enjoy even the "psychic income" of witnessing the gift being put to use. It is difficult to believe that any similar benefit could flow to his family, who, as indicated, are deprived of funds by reason of the gift.

Horizontal and vertical equity. It has been said that because of the rate structure and the manner in which the tax is imposed, the estate tax violates equity horizontally and vertically insofar as comparable taxpayers are concerned. The structure is not fair horizontally in that where there are two estates of the same size and one has a charitable contribution, the one with a charitable contribution pays a lesser tax. Vertical inequity is said to occur because of the progressive rates: Where the bequest in two different size estates are the same, the bequest in the larger estate will reduce the estate taxes by a larger amount than the same bequest in the smaller estate.

Again, the label "equity" does not necessarily lead to the conclusion that these results are unfair. If there is an estate of $1,000,000 and an estate of $500,000 and if the decedent of the larger estate bequeathes $500,000 to charity, is there any reason why both estates should not be treated as $500,000 estates for federal estate tax purposes? The $500,000 bequeathed by the larger estate would have been set aside for public purposes. Under such circumstances, this might be considered quite "equitable." Why should not the assets subject to the tax be only those set aside for private purposes. This in the case of both estates is $500,000. By the same token, is there any reason why two estates of $1,000,000 should be treated alike for estate tax purposes where one decedent reserves all of the assets for family and friends and the other bequeathes half outright for charitable purposes. In the one case $1,000,000 has been retained for private purposes and in the other only $500,000.

The structure permits an unfair private allocation of funds. This criticism is basically related to and part of the horizontal and vertical equity arguments. It is the same criticism that has been made of the charitable contribution deduction under the federal income tax and stems, of course, from the progressive rates in both the federal income tax and estate tax. It argues that where an estate is in the 50 percent bracket, the bequest of $100 is in reality 50 percent from the decedent and 50 percent from the federal government, being the amount of tax that would have been paid had no deduction been allowed for the charitable contribution. Thus, the individual has made a private allocation to the charity of his choice of the government's $50. The argument somehow presupposes that the assets are the joint property of the federal government and the decedent's estate. It also ignores the basic premise of the charitable contribution deduction, which is that it is designed to encourage private choices in philanthropy because of the overall benefit to the whole.

More important, it appears to assume that there is a measurable "benefit" to the testator which results from the allocation. While there might conceivably be "psychic" income to a donor making a gift during his lifetime, there can be no such benefit to the decedent by reason of his prior death. The family of the decedent is worse off by reason of the bequest. If it had not been made, they would have at least received the difference between the amount of the bequest and the tax. Even in the case of a bequest to a private foundation, the benefit to the family is fleeting. Indeed, if the history of the major United States foundations is any indication, over a reasonably short period of time the control of such organizations passes outside of "family." Whatever psychic income survives is more than offset by the rigid requirements and restrictions imposed by the Tax Reform Act of 1969.

Moreover, the government plays a significant role in the allocation in two ways. In the first place, it determines, through limitation in the tax laws, the entities that are benefited, directly or indirectly, by bequests. In the second place, it takes account of the private support that charities receive through bequests in allocating its funds to other activities.

The three criticisms described above, which are very much interrelated, are difficult to quantify. In fact, whether or not equity is offended by the charitable contribution deduction depends upon personal judgment. A fourth criticism is that the allowance of the charitable contribution deduction results in the imposition of additional burdens on the estates of those individuals who do not claim it.

Again, we lack firm figures. Based upon the estimates of at least one analyst, the placing of a 50 percent ceiling on estate tax charitable deductions would result in a tax revenue of approximately $270,000,000 annually.[13] In terms of the federal revenue, this is a minuscule amount and probably would constitute less than 7 percent of the collections from the estate tax itself, which, as indicated above, is itself not a significant factor in the annual revenue collections.

It is reasonable to suppose that all of the additional revenue would in fact come from the share or portion of the estates bequeathed to the charities. Indeed, a substantial portion of the $400 to $700 million of denied deductions is likely to come from bequests of the whole estates. In such cases, there is no entity other than the charities to bear the burden of the revenue collected. If, as suggested above, nearly 80 percent of the charitable bequests find their way into educational and social welfare programs, it would seem that virtually all of the revenue saved would have to be reallocated in one way or another to those services previously supported by the contributions. If, as feared, the imposition of the tax causes testators to divert the excess over 50 percent to other purposes (such as bequests to family and friends), then the loss to the charities would be much greater than the revenue gained. Correspondingly, the government may eventually be required to provide sums in addition to the revenue lost as a substitute for the funds that are thereby denied to the charities.

The Charitable Deduction and the Objectives of the Estate Tax Statute

If, as suggested above, the principal purpose for the estate tax deduction was the redistribution of wealth (regardless of whether that purpose has been achieved), then the charitable contribution deduction would seem to be as fully effective a method of redistribution as the tax itself. Not only is the wealth in question permanently allocated outside of the testator's family and friends, but the wealth is redistributed in a manner that commits it to use for public purposes. The redistribution may be even more effective than if the tax had been imposed if, as many assume, testators react unfavorably to a limitation by bequeathing to the family the portion of the estate above 50 percent for which a charitable contribution would no longer be available. Because of the kinds of charitable beneficiaries favored by testators, this kind of redistribution would seem to be particularly desirable.

Such redistribution affected by a bequest to a private foundation may have special advantages by reason of the controls imposed upon such foundations by the Tax Reform Act of 1969. The restrictions on any dealings involving conflict of interest and the requirements of a substantial annual distribution and precise accountability may have made the private foundation into an entity that is in some ways more "public" than many entities recognized as such. The provisions with respect to required disposition of excess business holdings are such as to provide a particularly orderly way of affecting not just a redistribution of wealth, but an orderly disposal of large holdings in both public and private companies. If there remain particular problems with respect to the organization and operation of private foundations, then perhaps they should be dealt with by modifying the rules with respect to the foundations rather than discouraging bequests through imposition of some sort of limitation. This would be true unless, as seems very unlikely, a disproportionate amount of the assets fall into the hands of private foundations.

The Charitable Deduction as an Incentive to Support of Charitable Organizations

The difficulty of dealing with any suggested proposal to modify the estate tax deduction for charitable bequests is that we do not have sufficient information upon which to base a reasonable judgment, particularly as regards the effect of the deduction itself as an incentive. In this connection, it is instructive to review the arguments with respect to the same problem as it affects the federal income tax deduction. Prior to this year, on the basis of wholly tentative studies, there were many who argued that the charitable contribution deduction provided little, if any, incentive and that its revocation would not have a substantial effect on the some 20,000,000 American families who contribute to philanthropic and religious organizations annually.[14] The preliminary results of the first indepth study of the subject, by Professor Martin Feldstein of Harvard, suggest that the incentive is indeed substantial and that charitable contributions are measurably increased by the current provision of deductibility.[15] One might venture to guess that the "efficiency" of the federal estate tax deduction may be even greater than the income tax charitable contribution deduction. However, there is no study of external factors that would support this conclusion.

Before any attempt is made to modify the federal estate tax with regard to the charitable contribution deduction, such a study should be instituted, perhaps on more than one level. Professor Feldstein believes that there is a basis for making an analysis which could prove useful in making such judgments with respect to the federal estate tax. In addition, an attempt should be made to determine if there is any way of discovering with reasonable assurance of accuracy what effect a change such as a 50 percent limitation on charitable contributions would have on the personal decisions of testators.

Studies such as Professor Feldstein's are of necessity based upon such variables as inflation, change in rates, and the like. They do not necessarily measure the potential effect of a change on the psychology of donors. If the deduction were denied, in part or in whole, this might represent to many testators withdrawal of recognition on the part of the federal government of the useful and public character of the charities concerned. By way of example, Professor David Westfall in a supplemental statement to the Filer Commission has suggested that there be a floor below which charitable bequests would not be deducted. For example, an estate would be able to deduct only a testator's bequest that exceeds 5 percent of the gross estate. Such a denial could in the long run have a devastating effect on charitable bequests (and it would appear to produce very little, if any, revenue). This follows from the belief that large bequests are often traceable to wills wherein the testator originally included only conditional or minimal bequests to the charities concerned.

Effect of Changes in the Estate Tax Deduction

Even if the above-suggested studies were available, it is doubtful that one could securely predict the potential effect of substantial changes in the charitable deduction for federal estate tax purposes.[16] In such cases, there could be considerable risk that a change which was productive of relatively little revenue might substantially and permanently reduce bequests as a source of support for charitable institutions. The proponents of any change must be prepared to consider the effect on the need for beneficiary organizations to find alternate sources of support to replace that portion of bequest support that is lost by reason of any change. In fact, the only source available is the government itself, since it is fair to presume that the institutions concerned are exploiting to the greatest extent all other available resources. If as suggested above (and, again, a great deal more data are needed to validate such suggestions), most of the bequests, directly or indirectly, support entities whose services would otherwise have to be provided by the government, then a procedure for making that substitution must be found.

In the first place, there are some institutions, such as religious entities, that could not receive alternate support from government sources because of constitutional prohibitions.[17] Other entities, such as private foundations, either could not or would not be included in any governmental program. Equally important, it is difficult to conceive of Congress reallocating the revenue to charitable and educational institutions. Political choices, which strongly influence such allocations, would eliminate the possibility of any continuity of support which is so important to organizations of this sort. Because of the nature of the legislative process, decisions made on the basis of concepts and conditions in one year may actually affect later years when the conditions may be completely changed. A minimum stability would require that allocation be made through authorization and appropriation for a period of at least 10 years. It is difficult to believe that such a procedure would ever be adopted by Congress.

A further and serious danger is the federal involvement in all of the charitable and educational institutions that would necessarily follow any kind of federal grant program. It is likely that it would substantially change the character of many, if not all, of the beneficiary charitable and educational institutions. Moreover, the conditions imposed on the grant itself might deprive the institution of the absolutely vital source of support now provided by the private sector, namely, the unconditional gift. Suggestions, such as Professor Paul McDaniel's, for a federal matching grant program should be carefully examined since they appear to suffer from virtually all of the above deficiencies.[18] Moreover, because of the limit on the kinds of beneficiaries, it would amount to a crude and perhaps improvident reallocation. At the very least, the effects of that reallocation should be carefully considered.

III

CONCLUSIONS

It would seem that the first priority in considering any change in the federal estate tax deduction for charitable bequests is to obtain as much information as possible concerning the effect of the change on revenue and on the support of beneficiary organizations. In considering any change, the "equities" as perceived must be taken into account. However, it would seem that the concept of "equity" should be most carefully scrutinized. The public benefit from private support of code-qualified charitable and educational institutions should have priority. It is difficult to see why changes should be offered except where there is a clear and substantial gain in revenue. In measuring that revenue gain, consideration must be given as to how and to what extent the federal government may be required to offset the losses of private support to the beneficiary charitable organizations. Finally, the effect of reallocation of support on the "quality" of charitable organizations should certainly be taken into account.

Because of the substantial risks of loss of support to charitable organizations that may result from a change in the tax structure, it would be far better to focus on making certain of the "public" nature of the beneficiary organizations (such, as for example, was done by the Tax Reform Act with respect to private foundations) than to tinker with the charitable bequest deduction where it would appear that the full and exclusive advantage, in any financial sense, flows to the beneficiary organizations.

Appendix A

Table A

Distribution of Estimated Charitable Bequests By All 1957 and 1959 Estate Tax Returnees By Purpose of Recipient Organization

(in thousands of dollars)

		Purpose of Recipient Organization			
Gross Estate Size	Religious[a]	Scientific, Literary, Educational	Social Welfare	Other	Total
Small	$82,082 28.1%	$27,243 9.3%	$181,057 61.9%	$2,117 0.7%	$292,499 100.0%
Medium	48,032 20.5	71,627 30.6	105,728 45.1	9,031 3.8	234,418 100.0
Large	44,460 6.3	188,649 26.8	270,941 38.5	199,741 28.4	703,791 100.0
Totals	$174,574 14.2%	$287,519 23.4%	$557,726 45.3%	$210,889 17.1%	$1,230,708 100.0%

a. Includes an estimated $4,609,000 bequeathed to fraternal, lodge, or veteran organizations. See J. M. Schafer, "Charitable Transfers at Death Under the Federal Estate Tax" (unpublished thesis in Columbia University Library, 1966), p. 173.

Appendix B

FOUNDATION GRANT STUDY

A study was made of the grants of the 29 largest foundations.[1] Because of their size and the amount of their grants, these foundations are representative of foundation activities in general. They accounted for 46 percent of total foundation assets of $27 billion[2] and made grants of $513 million, or 25 percent of the total foundation payments ($2.05 billion) for 1971.[3] The results of the study show a remarkably consistent grant pattern among foundations, with the bulk of grants made for educational and social welfare purposes. The cumulative results are summarized in Table B-1.

Table B-1

Summary of 1971 Grants of 29 Largest Foundations

Primary Purpose of Grants	Dollar Amount of Grants (in millions)	Percent
Education	$211	41%
Social welfare	173	34
Health	69	13
Humanities	46	9
Science	10	2
Religion	4	1
	$513	100%

Table B-2 supplies a breakdown of the grants of each foundation.[4] With a few exceptions, the figures represent 1971 appropriations.

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[1] The selection of the 29 largest foundations was made from the chart in *Giving U.S.A.* (1972) entitled "Largest U.S. Private Foundations Ranked by Payment of Grants." This chart also includes a listing of the current (1971) asset value of these foundations. See American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.*, 1972, p. 19.

[2] Ibid, p. 8.

[3] Ibid. The $513 million figure represents appropriations, whereas the $2.05 billion figure reflects actual payments. This was done because the *Foundation Grants Index*, a primary statistical source, uses appropriations figures.

[4] One exceptionally large grant — $54 million paid to Longwood Gardens by the Longwood Foundation — was not included. Of this $54 million grant, $45 million was in securities to be used for the creation of an endowment fund and $9 million was in the form of operating assets such as gardens, furniture, equipment, books, and supplies. Longwood Gardens, a horticultural exhibit, was originally owned and operated directly by the foundation. The foundation was subdivided in 1970 into Longwood Gardens, Inc., and the Longwood Foundation, Inc. This was a highly unusual payment, not easily lending itself to traditional categorization. Actually, it was not a grant but a realignment of funds and property. For these reasons, it has been deleted from the study. The *Foundation Grants Index 1970-1971* also does not include this amount in its cumulative list of foundation grants, nor is it included in the total amount of foundation grant payments.

In a few cases, which are noted, appropriations were not available so actual payments were substituted. No significant distortion should result from this. In one case 1972 appropriations had to be used since no separate statement was made of either 1971 appropriations or payments.

Following is an explanation of the categories and subcategories used in Table B-2:

EH	Higher Education: including undergraduate and graduate levels; medical and legal education; scholarly research.
EO	Elementary, Secondary, and Other Education: including libraries; vocational, adult, and community education.
HE	Health and Medical Care: including community health services and health services for mentally retarded, physically handicapped, and the aged; excluding medical education.
HU	Humanities: including theatre, symphony, historic preservation, museums, and crafts.
RE	Religion: including religious education; pastoral counseling, and ministerial pension system.
S	Science: including research in pollution control, neuroscience, and food resources.
SW	Social Welfare: including community development; social services; childcare and youth facilities; environment, conservation and recreation; drug and alcohol problems; police training; crime prevention; legal, judicial, and administrative reform; assistance for minority groups; population control; non-medical services for mentally and physically handicapped perople; urban redevelopment; legal aid; voter education; public television; international activities.
O	Other: including foundation research.

The categorizing of grants is somewhat subjective since some grants are only briefly described and some can be classified under more than one category. The category "other" does not appear in Table B-2 because total grants in this category were less than 1 percent of all grants.

Table B-2

Analysis of 1971 Grants of the 29 Largest Foundations

Foundation	EH	EO	Total Education	HE	HU	RE	S	SW	O	Total Appropriations
Ford Foundation	$42,481,277	$23,285,265	$65,766,542	$ -	$24,864,292	$ -	$25,000	$102,929,351	$2,500	$193,587,685
Andrew W. Mellon Foundation	27,239,000	620,000	27,859,000	2,230,000	2,022,000	20,000	15,000	3,306,500	-	35,452,500
Rockefeller Foundation	6,741,457	1,570,550	8,312,007	1,758,000	2,053,446	-	4,528,663	15,532,332	295,000	32,461,448
Emily and Ernest Woodruff Foundation	840,000	345,000	1,185,000	16,385,000	755,000	-	-	10,101,000	-	28,426,000
W.K. Kellogg Foundation	16,172,190	452,093	16,624,283	3,882,202	-	-	20,000	6,409,265	-	26,935,750
Duke Endowment	10,098,800	-	10,098,800	6,953,800	-	1,085,200	-	853,800	-	18,991,600
Charles Stewart Mott Foundation	954,964	5,137,815	6,092,779	7,991,747	3,000	67,000	-	1,166,504	-	15,321,030
Longwood Foundation[a]	1,330,490	274,000	1,604,490	34,900	9,222,879	-	-	2,672,800	-	13,535,069
John A. Hartford Foundation	-	-	-	13,175,225	-	-	-	300,000	-	13,475,225
Carnegie Corporation	5,958,485	4,243,243	10,201,728	928,750	-	-	-	1,748,275	140,000	13,018,753
Houston Endowment[a]	8,437,755	481,225	8,918,980	1,507,500	1,176,200	10,545	840	1,205,651	5,600	12,825,316
Alfred P. Sloan Foundation	7,244,778	147,600	7,392,378	400,000	9,000	-	3,559,135	327,250	-	11,687,763
Lilly Endowment, Inc.[a]	2,936,200	1,485,550	4,421,750	432,750	1,042,000	894,000	-	3,086,100	10,000	9,886,600
Rockefeller Brothers Fund	1,002,075	513,050	1,515,125	200,000	692,400	312,750	-	6,786,881	-	9,507,156
Richard King Mellon Foundation[b]	3,731,800	934,000	4,665,800	1,195,000	688,046	-	-	2,743,000	-	9,291,846
Kresge Foundation	5,541,000	294,000	5,835,000	989,000	202,000	385,000	-	1,583,363	-	8,994,363
Bush Foundation	3,309,068	592,150	3,901,218	1,291,798	1,915,000	-	300,000	1,316,845	-	8,624,861
Danforth Foundation	6,143,270	737,000	6,880,270	14,680	-	12,000	-	574,820	50,000	7,531,770
Commonwealth Fund	3,517,509	-	3,517,509	2,838,834	-	-	-	60,000	-	6,416,343
Moody Foundation[a]	657,300	1,496,736	2,154,036	997,669	257,500	25,000	7,442	1,666,826	18,500	5,126,973
Surdna Foundation[a]	1,470,000	160,000	1,630,000	127,000	500,000	60,000	-	2,102,000	-	4,419,000
Pew Memorial Trust[a]	1,510,005	106,188	1,616,193	505,080	84,040	863,400	12,480	1,166,181	101,760	4,349,134
Sarah Mellon Scaife Foundation	1,856,500	132,600	1,989,100	110,000	120,000	24,000	325,000	1,750,694	-	4,318,794
Z. Smith Reynolds Foundation	2,423,500	106,000	2,529,500	882,000	150,200	-	-	563,200	-	4,124,900
Robert Wood Johnson Foundation[a]	185,340	5,000	190,340	2,975,000	-	-	-	194,500	-	3,359,840
William R. Kenan, Jr. Charitable Trust	3,350,000	-	3,350,000	-	-	-	-	-	-	3,350,000
Charles F. Kettering Foundation	24,000	1,100,000	1,124,000	37,000	6,000	22,500	1,114,000	493,000	65,342	2,861,842
James Irvine Foundation	1,085,460	127,252	1,212,712	804,000	-	-	-	769,752	-	2,786,464
Edna McConnell Clark Foundation[c]	30,020	-	30,020	-	-	-	-	1,985,151	-	2,015,171
Total	$166,272,243	$44,346,317	$210,618,560	$68,546,935	$45,745,003	$3,781,395	$9,907,560	$173,395,041	$688,702	$512,683,196

a. Payment figures were used since appropriations figures were not available.
b. Appropriations for 1972.
c. Includes payments for New York foundation only; figures for Delaware foundation unavailable.

Appendix C

SUMMARY OF FOUNDATION CENTER STUDY

Another study of the grant-making patterns of private foundations is that annually compiled by the Foundation Center. This study is available through the *Foundation Grants Index*, which in turn relies on reports published in *Foundation News.*[1] An important feature of this study is that it is comprehensive for grants of $10,000 or more. That is, it includes all grants of $10,000 or more made by every private foundation in the United States. The grants included in this study total $1,066 million or 52 percent of all foundation giving for 1971.

Because of the more comprehensive nature of this study, it provides an interesting comparison with the preceding study, summarized in Appendix B. The preceding study covered grants of all amounts but did not cover all foundations. This study covers all foundations but excludes grants of less than $10,000.

In order to facilitate comparison, the categories and subcategories used in the *Foundation Grants Index* have been adjusted to conform with those of the preceding study. Accordingly, the *Index's* subcategories of Medical Education and Education (under International Activities) have been reclassified into Education. The *Index's* subcategory of Medical Research has been moved into Health. As there is no separate division for International Activities, these grants were reclassified into the other categories, depending on the purpose of the grants.

After reclassification, the results of the 1971 study are as follows:

Primary Purpose	Dollar Amount of Grants (in millions)	Percent
Education	$405	38%
Social Welfare	252	23
Health	160	15
Humanities	103	10
Science	73	7
Religion	73	7
	$1,066	100%

These results are especially interesting since they so closely parallel those of the study summarized in Appendix B. The order of categories is exactly the same suggesting that foundations do in fact heavily favor educational and social welfare purposes. There are, of course, differences in the percentage allocations to each category, although considerable similarity is demonstrated. The distribution pattern for 1970 grants reported in *Foundation News* exhibits the same order of priorities.

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[1] *Foundation News* is published by the Council on Foundations. The Foundation Center prepares and copyrights the *Foundation Grants Index*, which appears bimonthly in *Foundation News* and is consolidated yearly and published as a separate book. The center's source of information is usually a direct communication from the granting foundation itself; otherwise, information is culled from recently published annual reports, press releases, or other primary sources. Some small renewal grants are not listed. Conditional grants or pledges are omitted unless there is knowledge of payment. See, *Foundation Grants Index 1970-1971*, p. ix.

It is interesting to observe that educational grants have a long history of being favored by foundations. An examination of the last 11 years (1961-1971) reveals that education was the principal recipient of foundation grants in each of those years. In fact, it has been suggested that "probably more than half of all foundation dollars went to Education broadly defined."[2] The exact percentages for Education for 1961 through 1971 are as follows:

Education
(Percent of Total Grants)

Year	*Percent*
1961	31%
1962	46
1963	26
1964	33
1965	25
1966	24
1967	33
1968	41
1969	30
1970	36
1971	38

It is instructive to compare the distribution patterns for foundation grants with total giving from all sources for the same year.

Total Giving 1971
($21.15 billion)

	Percent
Religion	40.7%
Health and hospital	16.0
Education	15.6
Social welfare	7.3
Civic and cultural	6.6
Other	13.7

Source: American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.*, 1972, p. 6.

Education, which ranked first in both foundation studies, was only third among all donors, while religion, which ranked last among foundation grants, was clearly first among all donors.

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[2] *Foundation Grants Index 1970-1971*, p. xvi.

APPENDIX D

Table D-1

Charitable Bequests Reported on Estate Tax Returns, 1916-1970

(in millions of dollars)

Filing Year	Gross Estate	Charitable Bequests	
		Amount	As % of Gross Estate
1970	$29,671	$2,132	7.2[a]
1966	21,936	1,309	6.0
1963	17,007	876	5.2
1961	14,622	951	6.5
1959	11,648	669	5.7
1955	7,467	398	5.3
1954	7,412	355	4.8
1951	5,505	274	5.0
1950	4,918	206	4.2
1949	4,933	296	6.0
1948	4,775	223	4.7
1947	4,224	186	4.4
1945	3,437	192	5.6
1944	2,908	202	6.9
1943	2,627	186	7.1
1942	2,725	153	5.6
1941	2,778	176	6.3
1940	2,633	144	5.5
1939	2,746	178	6.5
1938	3,047	200	6.6
1937	2,768	127	4.6
1936	2,296	128	5.6
1935	2,435	106	4.4
1934	2,244	146	6.5
1933	2,026	96	4.7
1932	2,796	191	6.8
1931	4,042	220	5.4
1930	4,109	223	5.4
1929	3,844	154	4.0
1928	3,503	216	6.2
1927	3,146	131	4.2
1926	3,386	227	6.7
1925	2,958	116	4.0
1924	2,350	66	2.8
1923	2,495	74	3.0
1922	2,879	196	6.8
1916-21[b]	8,786	264	3.0

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1974

a. The figures for 1970 would be 5.5 percent if the outlier is omitted.
b. December 15, 1916, through January 15, 1922.

Source: Emil M. Sunley, Jr., "Dimensions of Charitable Giving Reported on Federal Estate, Gift, and Fiduciary Tax Returns," paper prepared for the Commission on Private Philanthropy and Public Needs.

Table D-2

Charitable Bequests by Size of Total Estate, 1970

(in millions of dollars)

Size of Total Estate	Number of Estates	Total Estate	Charitable Bequests Number of Returns	Amount	% of Total Estates
Under $300,000	117,288	$14,103	13,798	$350	2.5%
$300,000-under $1 million	14,111	6,903	3,498	364	5.3
$1 million-under $10 million	2,482	5,241	1,012	507	9.7
$10 million or more[a]	63	1,198	48	911	76.0[b]
Total	133,944	27,445	18,356	2,132	7.8%

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1974

a. Includes the outlier discussed in the text.

b. Would be 30.3 percent if the outlier is omitted.

Source: Statistics of Income, 1969

Table D-3

Charitable Bequests by Type of Recipient, 1939-1961

(in millions of dollars)

Filing Year	Total	Educational, Scientific, Literary Institutions: Publicly Owned	Educational, Scientific, Literary Institutions: Privately Owned	Religious	Other Charitable	Other Charitable as % of Total Charitable Bequests
1961	$951	$33	$81	$89	$748	78.7%
1959	669	31	117	86	435	65.0
1950	206	17	38	22	129	62.6
1949	296	16	98	35	147	49.7
1948	223	19	30	25	151	67.7
1947	186	7	26	25	127	68.3
1945	192	19	27	17	129	67.2
1944	202	18	32	16	136	67.3
1943	186	17	47	20	102	54.8
1942	153	9	23	16	107	69.9
1941	176	11	26	13	126	71.6
1940	144	8	19	17	100	69.4
1939	178	7	44	16	111	62.4

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Office of Tax Analysis

March 5, 1974

Source: Statistics of Income, various years.

Note: 1939 is the first year for which a breakdown is available for charitable bequests by type of recipient.

Table D-4

Charitable Bequests by Type of Recipient and Size of Gross Estate, 1961

(in millions of dollars)

	Charitable Bequests					
		Educational, Scientific, Literary Institutions				
Size of Gross Estate	Total	Publicly Owned	Privately Owned	Religious	Other Charitable	Other Charitable as % of Total Charitable Bequests
Under $300,000	$154	$ 5	$11	$42	$ 96	62.3%
$300,000 – under $1 million	168	8	17	24	120	71.4
$1 million – under $10 million	307	12	38	22	236	76.9
$10 million or more	322	9	15	1	297	92.2
Total	$951	$34	$81	$89	$749	$78.7

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1974

Source: Statistics of Income, 1960.

Footnotes

1. Internal Revenue Code of 1954, § 2055(d). All references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

2. See, *Panel Discussions on the Subject of General Tax Reform Before the House Committee on Ways and Means*, 93rd Congress, 1st Session, 1973, pt. 1, p. 225.

3. Act of July 14, 1870, ch. 225, §27, 16 Stat. 269. The tax under this section was not imposed where property was transferred "for public uses of a literary, educational or charitable character. . . ." ibid. See also, Act of August 27, 1894, ch. 349, §28, 28 Stat. 553, which treated bequests as income. A charitable deduction for inheritance related taxes was allowed, ibid., §32. See also, Act of June 27, 1902, ch. 1160, §1, 32 Stat. 406, which permitted a refund of taxes upon legacies and bequests of a religious, charitable, or educational character that had been imposed upon all legacies by the Act of June 13, 1898, ch. 448, §29, 30 Stat. 464. In the Revenue Act of 1918, a deduction for charitable bequests was included in the statute and has there remained until the present date. Revenue Act of 1918, ch. 18, §403(a)(3), (b)(3), 40 Stat. 1098-99. Such alterations in the scope of the deduction as have been adopted relate to the nature of the charities' activities, to the inclusion of certain organizations as allowable donees, and to assurances that the benefits for which the deduction has been given were, in fact, received by charities. For example, section 2055(a)(2) now provides a limitation on political activities and propaganda; sections 2055(a)(3) and (4) now allow donations to lodges and veterans' organizations; and section 2055(c) now limits the payment of taxes out of bequests to charity.

4. H.R. Rep. No. 1702, 57th Congress, 1st Session, 1902, 2. Compare the reference to "a hand in the contribution boxes" with Chairman Mill's reference to "a major stockholder in a man's pocketbook" in the colloquy referred to in note 2, sup[illegible]

5. 57 Congressional Record, 1918, p. 550.

6. *Prospective or Suggested Revisions in Federal Estate and Gift Taxation, Trusts and Estates,* Vol. 112, No. 2 (February 1973), p. 102.

7. Message of President Franklin D. Roosevelt (1935).

8. American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.*, 1973, p. 12.

9. Julian H. Levi and Sheldon E. Steinbach, *Patterns of Giving to Higher Education II*, American Council on Education, 1973.

10. S. K. McNees, "The Economic Effects of the Charitable Contributions Deduction Provision in the Federal Estate Tax" (unpublished thesis in Massachusetts Institute of Technology Library, August 1970), pp. 123-25. See also, J. M. Schaefer, "Charitable Transfers at Death Under the Federal Estate Tax" (unpublished thesis in Columbia University Library, 1966), pp. 40-107, and Emil M. Sunley, Jr., "Dimensions of Charitable Bequests Reported on Federal Estate, Gift, and Fiduciary Tax Returns," paper prepared for the Commission on Private Philanthropy and Public Needs, 1974. (The author has not had direct access to the McNees and Schaefer theses.)

11. American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.*, 1972, p. 27.

12. Sunley, op. cit.

13. McNees, op. cit.; Sunley, op. cit.

14. M. K. Taussig, "The Charitable Contributions Deduction in the Federal Personal Income Tax" (unpublished thesis in Massachusetts Institute of Technology Library, August 1965).

15. Martin S. Feldstein, "On the Effects of the Income Tax Treatment of Charitable Contributions: Some Preliminary Results," paper prepared for the Commission on Private Philanthropy and Public Needs.

16 See Michael J. Boskin, "Estate Taxation and Charitable Bequests," paper prepared for the Commission on Private Philanthropy and Public Needs, 1975. This paper, which was not available at the time of the present study, found that for every $1 gained in revenue, $4.40 would be lost to charity, which bears out the prediction of the disproportionate loss to charitable organizations of tax revenue gained.

17 See *Lemon v. Kurtzman*, 403 U.S. 602.

18 Paul R. McDaniel, "Study of Federal Matching Grants for Charitable Contributions," paper prepared for the Commission on Private Philanthropy and Public Needs.

DIMENSIONS OF CHARITABLE GIVING REPORTED ON FEDERAL ESTATE, GIFT, AND FIDUCIARY TAX RETURNS

Emil M. Sunley, Jr.†

Summary of Data

The paper summarizes the available data on the amount of charitable giving reported on federal estate, gift, and fiduciary tax returns.

Estate Tax Returns

- In 1973, the 175,000 estate tax returns that were filed represented only about 9 percent of the total number of estates.
- A charitable deduction was claimed on 21,000 returns, about 12 percent of all returns filed.
- Charitable bequests of $2.0 billion were deducted by these estates.
- These bequests represented 5.1 percent of the gross estate reported on all estate tax returns.
- Charitable bequests accounted for a significantly greater proportion of large estates.
- One third of the charitable deduction for all estates was in excess of 50 percent of the economic estate.
- Very little data are available on charitable bequests by type of recipients.

Gift Tax Returns

- For 1965, the last year for which data are available, the total amount of charitable gifts reported on gift tax returns was $524 million.
- These charitable gifts represent about 13 percent of the total gifts reported on gift tax returns.
- There may well be considerable underreporting of charitable gifts since these gifts are nontaxable.
- The 256 returns reporting charitable gifts of $1 million or more reported 47 percent of the charitable gifts reported on all gift tax returns.

Fiduciary Income Tax Returns

- Less than 3 percent of estates and trusts for which fiduciary income tax returns were filed in 1970 reported a charitable deduction.
- The total charitable contributions of fiduciaries was $469 million.
- All but the $30 million attributed to tax-exempt income or excluded capital gains was deductible on fiduciary income tax returns.

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- Estates claimed a charitable deduction of $142 million which represented about 5.4 percent of the total income of estates.
- Trusts reported a charitable deduction of $297 million which represented about 4 percent of trust income.
- The amount of charitable deduction reported on fiduciary tax returns as a percentage of total income has increased from 1.9 percent in 1954 to 4.3 percent in 1970.

I

ESTATE TAX RETURNS

The present federal estate tax was imposed in 1916 at rates ranging from 1 to 10 percent. The rates were sharply increased in the 1930s, and in 1941 the present rate structure was adopted with rates ranging from 3 percent on the first $5,000 of taxable estate to 77 percent on the amount of the taxable estate in excess of $10 million.

An estate is required to file an estate tax return only if the gross estate, which consists of all property owned by the decedent, exceeds $60,000. In 1973, 175,000 estate tax returns were filed. Though these estates represent only about 9 percent of the total number of estates, they reported gross estates of $38.9 billion and economic estates[1] of $33.8 billion.

In determining the taxable estate, deductions from the gross estate are allowed for funeral expenses, expenses incurred in administering the estate, debts, charitable bequests, and the marital deduction (bequests to the surviving spouse up to one half of the estate). In 1973, charitable bequests of $2.0 billion were deducted on estate tax returns. ("Charitable bequests" is not strictly accurate because the charitable deduction reported on estate tax returns includes some lifetime charitable gifts which must be included in the gross estate. For purposes of this paper the terms "charitable bequests" and "charitable deductions" will be used interchangeably.) This is larger than the amounts deducted for funeral and administrative expenses ($1.7 billion), but smaller than the deduction for debt ($2.2 billion) and the marital deduction ($7.5 billion).

A $60,000 exemption is also subtracted in obtaining the taxable estate. In 1973, 121,000 returns (out of the 175,000 returns filed) were taxable. These returns, which represent only about 6 percent of the total number of estates, reported taxable estates of $15.8 billion. Graduated rates were applied to this tax base, and the tax liability before credits was $4.7 billion, implying an average tax rate of 14 percent on economic estates. The federal tax liability was further reduced to $4.2 billion by several tax credits, the most important being the limited credit for state death taxes.

Unlike the federal individual and corporate income taxes, the estate tax contains no limit on the amount that can be deducted on an estate tax return for property transferred to "charitable organizations," a term that includes (1) the United States, any State, territory, or political subdivision thereof, or the District of Columbia; (2) corporations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals; (3) a fraternal society or association operating under the lodge system; and (4) veterans' organizations. In contrast to the income tax, the estate tax includes no requirement that the organization must have been created under domestic laws.

Time Series Data

Table 1 gives the sum of gross estates for which returns were filed and their charitable bequests for selected years 1916 to 1973.[2] For 1970, charitable bequests were equal to 7.2 percent of gross estate, the highest percentage for any year included in the table. This result, however, is due largely to an outlier,[3] and if this one estate is omitted from the 1970 data, charitable bequests would be equal to 5.5 percent of gross estate.

After adjusting the 1970 data for the outlier, charitable bequests as a percent of gross estate show no major time trend. This is probably misleading, however, because by 1973 estate tax returns were filed with respect to about 9 percent of all decedents. In the early years of the estate tax even up to 1945, estate tax returns were filed with respect to less than 1.5 percent of all decedents. This broadening of the estate tax, due largely to growing wealth levels, inflation, and the fact that the $60,000 exemption has remained unchanged since 1942, has meant that many small estates when measured in real terms are now required to file estate tax returns. It will be shown in the next section that charitable bequests are less common for small estates. Thus, the increased presence of small estates holds down the ratio of charitable bequests to gross estate.

The number of returns with gross estates of $300,000 or more in 1973, as shown in Table 2, represents about 1.2 percent of decedents, and thus these estates represent roughly the same proportion of decedents as represented by all estate tax returns filed in the 1920s and 1930s. It is estimated that these estates reported charitable bequests equal to about 8 percent of gross estate. This suggests that a larger proportion of property transfered at death goes to charitable organizations now than was the case in the 1920s and 1930s.

Charitable Bequests by Size of Total Estate

Table 2 indicates that in 1973 a charitable deduction was claimed on 21,257 returns, about 12 percent of all returns filed that year. The frequency of claiming a charitable deduction, however, varied directly with the size of the estate. For estates of under $300,000, 10 percent of the returns claimed a charitable deduction. For the very largest estates, estates of $10 million or more, 75 percent of the returns claimed a charitable deduction.

Table 2 also indicates that charitable bequests accounted for a significantly greater proportion of the estate for large estates than small estates. For estates of under $300,000, 2.0 percent of the total estate was left to charity. This percentage increases to 8.1 percent for estates of $1 to $10 million and to 31.2 percent for estates of $10 million or more.

Charitable Bequests in Excess of Designated Percentages of Economic Estates

Table 3 gives the amount of charitable deductions that exceeded designated percentages of economic estate for returns filed in 1973.[4] For estates under $1 million, 36 percent of the charitable bequests was in excess of 50 percent of the economic estate, and for estates over $10 million, 27 percent of the charitable deduction was in excess of 50 percent.[5] For all estates, one third of the charitable deduction was in excess of 50 percent of the economic estate. Put another way, if Congress limited the charitable deduction to 50 percent of the economic estate, one third of charitable bequests would not be deductible.

Table 1

Charitable Bequests Reported on Estate Tax Returns, 1916-1973

(in millions of dollars)

Filing Year	Gross Estate	Charitable Bequests	
		Amount	As % of Gross Estate
1973	$38,869	$1,996	5.1%
1970	29,671	2,132	7.2[a]
1966	21,936	1,309	6.0
1963	17,007	876	5.2
1961	14,622	951	6.5
1959	11,648	669	5.7
1955	7,467	398	5.3
1954	7,412	355	4.8
1951	5,505	274	5.0
1950	4,918	206	4.2
1949	4,933	296	6.0
1948	4,775	223	4.7
1947	4,224	186	4.4
1945	3,437	192	5.6
1944	2,908	202	6.9
1943	2,627	186	7.1
1942	2,725	153	5.6
1941	2,778	176	6.3
1940	2,633	144	5.5
1939	2,746	178	6.5
1938	3,047	200	6.6
1937	2,768	127	4.6
1936	2,296	128	5.6
1935	2,435	106	4.4
1934	2,244	146	6.5
1933	2,026	96	4.7
1932	2,796	191	6.8
1931	4,042	220	5.4
1930	4,109	223	5.4
1929	3,844	154	4.0
1928	3,503	216	6.2
1927	3,146	131	4.2
1926	3,386	227	6.7
1925	2,958	116	4.0
1924	2,350	66	2.8
1923	2,495	74	3.0
1922	2,879	196	6.8
1916-21[b]	8,786	264	3.0

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a. The figure for 1970 would be 5.5 percent if one outlier is omitted.

b. September 9, 1916, through January 15, 1922. The charitable deduction was not allowable in the case of decedents who died before 1918.

Table 2

Charitable Bequests by Size of Gross Estate, 1973

(in millions of dollars)

Size of Gross Estate	Number of Returns	Gross Estate	Charitable Bequests		
			Number of Returns	Amount	% of Gross Estates
Under $300,000	151,302	$18,996	15,658	$ 383	2.0%
$300,000-under $1 million	19,569	9,619	4,090	350	3.6
$1 million-under $10 million	3,939	8,354	1,442	673	8.1
$10 million or more	89	1,900	67	592	31.2
Total	174,899	$38,869	21,257	$1,998	5.1%

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Source: Statistics of Income, 1972.

Table 3

The Amount of Charitable Bequests That Exceed Designated Percentages of Economic Estate, by Size of Economic Estate, 1973

(in millions of dollars)

Designated Percentage	Size of Economic Estate Under $300,000	$300,000-under $1 million	$1 million-under $10 million	$10 million or more	Total
0%	$474	$348	$645	$503	$1,970[a]
10	377	267	512	410	1,566
20	317	216	423	328	1,284
30	267	174	347	259	1,046
40	223	138	282	196	839
50	185	107	226	137	656
60	153	80	180	80	493
70	125	57	139	39	359
80	102	38	105	20	265
90	88	25	82	8	203
100	83	21	75	2	181

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a. Excludes $28 million of lifetime charitable gifts reported on returns of zero or negative economic estates.

Source: Special tabulation of 1972 Estate Tax Model.

Table 4

Charitable Bequests by Type of Recipient, 1939-1961

(in millions of dollars)

Filing Year	Total	Educational, Scientific, Literary Institutions		Religious	Other Charitable	Other Charitable as % of Total Charitable Bequests
		Publicly Owned	Privately Owned			
1961	$951	$33	$81	$89	$748	78.7%
1959	669	31	117	86	435	65.0
1950	206	17	38	22	129	62.6
1949	296	16	98	35	147	49.7
1948	223	19	30	25	151	67.7
1947	186	7	26	25	127	68.3
1945	192	19	27	17	129	67.2
1944	202	18	32	16	136	67.3
1943	186	17	47	20	102	54.8
1942	153	9	23	16	107	69.9
1941	176	11	26	13	126	71.6
1940	144	8	19	17	100	69.4
1939	178	7	44	16	111	62.4

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Source: Statistics of Income, various years.

Note: 1939 is the first year for which a breakdown is available for charitable bequests by type of recipient.

Table 5

Charitable Bequests by Type of Recipient and Size of Gross Estate, 1961

(in millions of dollars)

Size of Gross Estate	Total	Charitable Bequests: Educational, Scientific, Literary Institutions: Publicly Owned	Privately Owned	Religious	Other Charitable	Other Charitable as % of Total Charitable Bequests
Under $300,000	$154	$ 5	$11	$42	$ 96	62.3%
$300,000 to under $1 million	168	8	17	24	120	71.4
$1 million to under $10 million	307	12	38	22	236	76.9
$10 million or more	322	9	15	1	297	92.2
Total	$951	$34	$81	$89	$749	$78.7

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March 5, 1975

Source: Statistics of Income, 1960.

Charitable Bequests by Type of Recipient

Very little data are available on charitable bequests by type of recipient. For certain years, with the last year being 1961, the Internal Revenue Service has tabulated charitable bequests broken down by the categories shown in Table 4. "Other" bequests, which include bequests to private foundations, were 79 percent of charitable bequests in 1961. Since 1961 is the last year for which data are available, it is not possible from these data to discover whether the provisions relating to private foundations contained in the Tax Reform Act of 1969 have had an impact on the amount of bequests to private foundations.

Table 5 gives charitable bequests by type of recipient for four gross estate-size classes for 1961. For estates of $10 million or more, 92 percent of charitable bequests were "other" charitable bequests. Smaller estates tended to report a much smaller proportion of total charitable bequests going to "other" charitable organizations.

II

GIFT TAX RETURNS

The federal gift tax is somewhat more complicated than the federal estate tax because the tax base depends on total accumulated gifts since 1932. The tax due in any one quarter is the additional tax resulting from gifts made in that quarter.

An individual is required to file a gift tax return if he makes gifts during the year to one donee of either a present interest in the transferred property of over $3,000, or a future interest of any amount. Since 1971, the law has required the filing of gift tax returns and the payment of gift taxes on a quarterly rather than on an annual basis.[6] In fiscal year 1973, 244,000 gift tax returns were filed reporting $637 million of tax, which is about 15 percent of the tax reported on estate tax returns filed that year.[7]

For 1965, the last year for which the Internal Revenue Service tabulated gift tax returns, 113,000 returns were filed.[8] These returns reported $4.0 billion of gifts made in that year.

There are several adjustments to get from total gifts of the donor to the tax base. First, if a husband or wife consent, a gift made by either of them to a third party may be considered as made one half by each. Total gifts after splitting were $3.8 billion[9] in 1965.

Second, the first $3,000 of present-interest gifts to each recipient is excluded.[10] Both charitable and noncharitable gifts are eligible for the $3,000 exclusion. Exclusions on all gift tax returns for 1965 were $900 million, and exclusions applicable to gifts made to charitable institutions were $65 million.

Third, gifts to charitable institutions are deductible and thus excluded from the tax base. For 1965, charitable gifts of $459 million were deducted on gift tax returns. The total amount of charitable gifts reported on gift tax returns, therefore, was $524 million (the $459 million deduction plus the $65 million exclusion). These charitable gifts represent about 13 percent of the total gifts reported on gift tax returns. It may well be that there is considerable underreporting of charitable gifts since these gifts are nontaxable.

Fourth, under the gift tax, a marital deduction is provided. In general, one half of noncommunity property transferred to a spouse may be deducted. This deduction reduced total gifts for 1965 by $150 million.

Fifth, a lifetime specific exemption of $30,000 is allowed. This exemption is allowed only once, but it is cumulative until used up. For 1965, gift tax returns reported specific exemptions totaling $830 million.

The five adjustments described above reduced the $4.0 billion of total gifts for 1965 to $1.5 billion of taxable gifts. There were 30,000 taxable returns.

To compute the tax, graduated rates are first applied to the total of all taxable gifts made since June 6, 1932. Then, the rates are applied to the total of all taxable gifts made prior to the current quarter. The difference between the two amounts is the gift tax for the current quarter. The gift tax rates are nominally three fourths of the estate tax rates. The effective rates are in fact lower because the gift tax is imposed on a tax base which excludes the tax while the estate tax must be paid out of the estate tax base. For 1965, gift tax revenue was $413 million. Just 10 returns, each reporting over $10 million of gifts, accounted for over 25 percent of the revenue.

Time Series Data

Table 6 gives the amount of total gifts before splitting and charitable gifts after exclusion for selected years 1932 to 1965.[11] Charitable gifts have ranged from as low as 5.3 percent of total gifts in 1935 (a year when total gifts were unusually high) to as high as 25.9 percent in 1932, the first year of the present gift tax. In recent years, charitable gifts after exclusion have averaged about 12 percent of total gifts.

Data on the amount of charitable gifts reported on gift tax returns is last available for 1965. Based on the expected revenue from the gift tax in 1974—50 percent greater than in 1965—charitable gifts reported on gift tax returns filed in 1974 should be about $750 million and charitable gifts after exclusion, $650 million. The American Association of Fund-Raising Counsel, Inc., estimates that charitable giving of individuals totaled over $18 billion in 1973.[12] Thus, less than 10 percent of the charitable gifts are reported on gift tax returns.

Charitable Gifts by Size of Total Gifts Before Splitting

Table 7 gives the amount of charitable gifts for 1965 by the size of total gifts before splitting. The 256 returns reporting gifts of $1 million or more reported charitable gifts of $244 million which equaled 47 percent of the charitable gifts reported on all gift tax returns. For all returns, charitable gifts were 13 percent of total gifts. For returns reporting gifts of $1 million or more, 29 percent of the gifts were charitable.

III

FIDUCIARY INCOME TAX RETURNS

Fiduciary income tax returns are filed to report the annual income of domestic estates and trusts. A return must be filed for a trust that had any taxable income, or for an estate or trust that had gross income of $600 or more regardless of taxable income, or for any estate or trust that had a nonresident alien beneficiary.

Prior to the Tax Reform Act of 1969, a trust or estate was allowed a tax deduction for any part of its gross income that was paid or permanently set aside for charitable, religious, scientific or other similar purposes. The deduction was generally allowed without limitation. The Tax Reform Act of 1969 eliminated, except for some grandfathering, the provision allowing trusts to deduct the amount set aside for charitable purposes but not actually paid to

Table 6

Charitable Gifts After Exclusions Reported on Gift Tax Returns, 1932-1966

(in millions of dollars)

Year[a]	Total Gifts before splitting[b]	Charitable Gifts After Exclusion	
		Amount	As % of Total Gifts
1965	$3,962	$459	11.6%
1962	2,650	334	12.6
1960	2,316	300	13.0
1958	1,870	237	12.7
1956	1,357	133	9.8
1953	1,012	128	12.6
1951	1,000	99	9.9
1950	1,064	140	13.2
1949	708	88	12.4
1948	741	132	17.8
1947	778	130	16.7
1946	756	102	13.5
1945	536	62	11.6
1944	499	71	14.2
1943	413	37	9.0
1942	480	40	8.3
1941	1,081	63	5.8
1940	570	73	12.8
1939	372	44	11.8
1938	400	28	7.0
1937	568	76	13.4
1936	483	48	9.9
1935	2,131	113	5.3
1934	889	74	8.3
1933	241	30	12.4
1932[b]	81	21	25.9

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a. Year prior to year of filing.
b. For gifts made June 6 to December 31, 1932.

charitable organizations. Congress concluded that it would be inconsistent to retain the set-aside deduction for trusts if at the same time foundations and charitable trusts were to be required to distribute all of their income currently. In the case of estates, the set-aside deduction was retained since it is often contrary to probate law for an estate to make current distributions to charity.

Estates and trusts are not allowed a deduction for contributions attributed to tax-exempt interest or the excluded half of net long-term capital gains in excess of net short-term capital losses. If the income used for charitable purposes is not specified by the governing instrument, it is assumed that the charitable contribution comes proportionately out of all items of trust or estate income.

In 1970 fiduciary income tax returns reported a deduction for charitable giving of $439 million. Table 8 gives the various components of that deduction. There was $310 million of contributions paid or set aside from current year's income. Of this amount, $30 million was attributed to tax-exempt interest or excluded capital gains and, therefore, not deductible. In addition, there was $44 million of contributions of capital gains of the current year allocable to corpus and $116 million of contributions which were not attributed to current year's income. The total charitable contributions of fiduciaries was $469 million—the $439 deducted plus the $30 million attributed to tax-exempt income or excluded capital gains.

Table 9 breaks out the charitable deduction by type of fiduciary. Estates claimed a charitable deduction of $142 million. This represented about 5.4 percent of the total income of estates and about one third of the total charitable deduction reported on fiduciary income tax returns. Trusts reported a charitable deduction of $297 million which was equal to 4 percent of trust income. About one third of the trust charitable deduction was reported on the returns of simple trusts[13] and two thirds on returns of complex trusts.[14] The charitable deduction was 8 percent of total income for complex trusts and 1.8 percent for simple trusts. The last two rows of Table 9 indicate that there was little difference between inter vivos trusts (created while the grantor was living) and testamentary trusts (created by the terms of the grantor's will after the grantor's death). Both types of trusts reported a charitable deduction of about $135 million which was equal to about 4 percent of the trust income.

As indicated in Table 10, the amount of the charitable deduction reported on fiduciary tax returns as a percentage of total income has increased from 1.9 percent in 1954 to 4.3 percent in 1970. During the same period, the amount of the charitable deduction increased six fold, from $72 million to $439 million.

For estates and trusts with a charitable deduction, Table 11 gives the number of returns, total income, and the amount of the deduction. Less than 3 percent of estates and trusts for which fiduciary income tax returns were filed reported a charitable deduction. For these estates and trusts, the charitable deduction averaged 51 percent of total income. There was no tendency for the charitable deduction as a percentage of total income to be higher for large estates and trusts than for small ones.

Table 8

Components of Charitable Deduction Reported on Fiduciary Income Tax Returns, 1970

(in thousands of dollars)

	Number of Estates and Trusts	Amount
1. Full amount of contributions paid or permanently set aside from current year's income	21,965	$309,525
2. Less contributions of tax-exempt interest and certain capital gains	4,111	30,421
3. Plus contributions of capital gains of the current year (allocable to corpus) paid or permanently set aside	5,934	43,875
4. Plus contributions which are not attributed to current year's income	8,211	116,213
5. Equals charitable deduction	30,621	439,194

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Source: Statistics of Income, 1970, Fiduciary Income Tax Returns.

Table 9

Charitable Deduction by Type of Fiduciary, 1970

(in millions of dollars)

Type of Fiduciary	Number of Returns	Total Income (less deficit)	Charitable Deduction Number of Returns	Charitable Deduction Amount	Charitable Deduction Percent of Total Income
Estates and Trusts	1,027,283	$10,124	30,621	$439	4.3%
Estates	274,885	2,610	8,695	142	5.4
Trusts	752,398	7,514	21,926	297	4.0
Simple	437,523	4,851	7,076	87	1.8
Complex	297,582	2,454	13,885	197	8.0
Not specified	17,293	208	965	13	6.3
Inter vivos	372,259	3,470	8,761	134	3.9
Testamentary	279,305	3,113	10,270	138	4.4
Not specified	100,834	930	2,895	25	2.7

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Source: Statistics of Income, 1970, Fiduciary Income Tax Returns.

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Table 10

Charitable Deduction Reported on Fiduciary Income Tax Returns, 1954-1970

(in millions of dollars)

Year	Total Income (less deficit)	Charitable Deduction	
		Amount	Percent of Total Income
1970	$10,124	$439	4.3%
1962	5,937	182	3.1
1960	5,267	153	2.9
1958	5,055	119	2.4
1956	4,884	93	1.9
1954	3,862	72	1.9

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Table 11

Estates and Trusts with Charitable Deduction: Number of Returns, Total Income, and Charitable Deduction by Size of Total Income, 1970

(in millions of dollars)

Size of Total Income	Number of Returns	Total Income (less deficit)	Charitable Deduction	
			Amount	Percent of Total Income
Under $50,000	27,199	$243	$125	51.4%
$50,000-under $100,000	2,003	139	52	37.4
$100,000-under $200,000	807	111	64	57.7
$200,000-under $500,000	422	122	79	64.8
$500,000-under $1,000,000	109	73	37	50.7
$1,000,000 or more	81	171	83	48.5
Total	30,621	$860	$440	51.0%

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Source: Statistics of Income, 1970, Fiduciary Income Tax Returns.

Footnotes

1. The economic estate is equal to the gross estate less lifetime transfers included in the estate and less debts and mortgages (except against insurance).

2. The table includes all years for which data are available.

3. One large estate tax return filed in 1970 reported lifetime charitable gifts in excess of $500 million which had to be included in the gross estate and which qualified for the charitable deduction. This one estate claimed over 25 percent of the charitable deduction claimed on all estate tax returns filed in 1970.

4. The data in Table 3 are somewhat distorted by the inclusion in the charitable deduction of some lifetime charitable bequests which must be included in the gross estates. These lifetime charitable bequests are not included in the economic estate (see note 1, supra).

5. From Table 3, 36 percent = (185 + 107) ÷ (474 + 348). The same process was used to derive the 27 percent figure.

6. Quarterly gift tax returns are not required for charitable gifts. Instead, the donor must report charitable transfers on a return for the fourth quarter of the calendar year or at such earlier time as he is required to file a return for a taxable gift.

7. *Annual Report, Commissioner of Internal Revenue* (1973), pp. 123, 136.

8. The large increase in the number of returns filed between 1966 and 1973 is due in part to the institution of a quarterly filing requirement in 1971.

9. Total gifts after splitting is $0.2 billion less than total gifts before splitting. This is so because a donor may make a gift of more than $3,000 but less than $6,000 and have to file while the spouse may not have to file because the divided half would be less than $3,000.

10. Thus for a married couple, the annual exclusion may be $6,000 per year for each recipient.

11. The table includes all years for which data are available.

12. American Association of Fund-Raising Counsel, Inc., *Giving USA*, (1974).

13. A simple trust must distribute all its income currently (determined under governing instrument and local law) and must not make charitable contributions (except for a few trusts permitted under local law). The amount of charitable deduction reported by "simple trusts" seems surprisingly high.

14. A complex trust either distributes to beneficiaries a portion of trust corpus or accumulates income.

DEATH, TAXES, AND CHARITABLE BEQUESTS: A SURVEY OF ISSUES AND OPTIONS

Richard E. Wagner[†]

Introduction

When people die, the State customarily steps in and claims a share of any wealth they leave behind.[1] Several issues concerning the extraction of a tax upon the occasion of a person's death have elicited interest and evoked controversy.[2] This paper focuses upon a subset of issues concerning taxation upon death, namely, those issues surrounding the tax treatment of charitable bequests within a system of death taxation.

Bequests to a variety of philanthropic institutions, including such public charities as various educational, cultural, and social welfare organizations, as well as private foundations and charitable trusts, are presently deductible from gross estate in determining a decedent's taxable estate.[3] The deductibility of charitable bequests has inspired intense controversy, as critics of deductibility have claimed that the charitable deduction should be regarded as a governmental subsidy for the charitable activities of the wealthy. The issues arising out of the charitable deduction, as well as the various policy options that emerge in response to alternative positions regarding these issues, shall be examined in the first chapter of this paper.[4]

Present tax rules create a strong incentive for donors to make charitable contributions in the form of appreciated capital assets. A donor, in contributing appreciated assets, is able to deduct the marketable value of such assets in determining his taxable income, but the capital gain is not counted as part of income. A contribution of appreciated assets, then, reduces a donor's tax liability in two ways: The implicit tax on the capital gain is avoided and the market value of the asset provides a deduction from gross income. The tax treatment of capital appreciation has also created considerable controversy, and raises issues that relate to both income taxation and estate taxation. In its 1969 proposals for tax revision, the Treasury recommended that such unrealized capital appreciation be taxed as income on the decedent's final income tax return, with the estate tax then being applied to the remaining estate. Whether unrealized capital appreciation should be taxed as part of the decedent's final income tax return, and whether a donor should be able to deduct the market value of appreciated assets given to charity, without at the same time counting the appreciation as part of income are two facets of the tax treatment of capital appreciation that shall be explored in Chapter II of this report.

In addition to these two primary elements of contention, I shall examine a third issue which revolves around the appropriate role of the State in relation to private philanthropy. This leads to matters pertaining to governmental regulation over charitable organizations, a topic that may be viewed essentially as one of the "industrial organization" of philanthropy. The Tax Reform Act of 1969, for instance, imposed special constraints on private foundations, but not on public charities. An examination of the properties and merits of this regulation of private philanthropy offers a propitious opportunity for examining several important and controversial issues regarding the respective roles of the State and of private philanthropic institutions, and this task is undertaken in Chapter III.

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I

IS THE CHARITABLE DEDUCTION A FORM OF GOVERNMENTAL SUBSIDY?

It is commonly argued that the charitable deduction amounts to a governmental subsidy, especially for the relatively wealthy members of society. By making bequests to charitable organizations deductible from gross estate in computing taxable estate, the amount of tax levied on an estate is reduced as charitable bequests are increased. With progressive taxation, moreover, the amount of tax deduction per dollar of bequest rises with the wealth of the donor. Not only is deductibility a form of governmental subsidy, so it is argued, but also it is a subsidy that increases with the wealth of the donor. It is this latter attribute of deductibility that has evoked the strongest hostility. A contrasting line of argument, however, suggests that the charitable deduction is a fully appropriate institution, for the deductibility of charitable bequests is viewed as being a necessary ingredient in arriving at an appropriate determination of taxable estate. This section of the paper first examines the view that the charitable deduction is a tax expenditure, then describes some alternative policy options that have emerged from this perspective, and then elucidates the view that the charitable deduction is fully appropriate as a matter of principle.

The Charitable Deduction as a Tax Expenditure

The charge that the charitable deduction is a form of governmental subsidy can be developed with a simple illustration. Suppose initially that there is no deductibility of charitable bequests, and that a taxable estate of $1 million is taxed at an average rate of 50 percent.[5] The State then claims $500,000, and of the remaining $500,000, $300,000 is left to private persons, and $200,000 is left to charitable institutions. Now let charitable bequests be fully deductible from the decedent's gross estate. Since the taxable estate falls to $800,000, the tax burden placed on the estate falls to $400,000. If charitable bequests remain at $200,000, the amount of wealth transferred to private persons will increase to $400,000. In this case, the making of a $200,000 charitable bequest reduces the amount remaining for heirs by only $100,000, for the other $100,000 is in effect financed by a reduction in tax collections.

In the more general case, part of the $100,000 reduction in tax liability would accrue to charitable organizations rather than to private persons. Suppose, for instance, that after the introduction of deductibility, charitable bequests rise to $300,000. The taxable estate is now $700,000, which yields a tax liability of $350,000. This leaves $350,000 for individual heirs, rather than $400,000, as in the preceding illustration. In either case, however, bequests to charitable organizations are financed in part by reductions in bequests to private persons and in part by reductions in tax collections by government. With a marginal tax rate of 50 percent, the introduction of deductibility means that an additional $100 of charitable bequests brings about only a $50 reduction in bequests to private persons, for the remaining $50 is financed by a reduction in governmental tax collections.

Through the use of such arithmetical analogies, it is often suggested that the charitable deduction should be viewed as a governmental subsidy—as a "tax expenditure," in contrast to a direct expenditure of public revenue. If the deductibility of charitable bequests were eliminated, the additional $50 of tax revenue that would accrue to the public treasury could be used to finance some program of direct public expenditure, in place of the financing of philanthropic activities that occurs through deductibility. The deductibility of charitable bequests, then, can be viewed as enabling individual testators to make decisions concerning the expenditure of public revenue, or, somewhat more accurately, the expenditure of what otherwise would have been public revenue. Under deductibility, part of the bequest to charitable institutions is financed by reductions in tax collections, rather than by reductions in bequests to private persons. Had deductibility not existed, tax collections would have been higher, so additional public expenditure could have been undertaken. Such considerations as these make the charitable deduction appear to be a diversion of government revenue from categories of expenditure that would have been chosen collectively to categories of expenditure that are chosen privately.

Moreover, if the charitable deduction is viewed as a government subsidy—as a tax expenditure—it is a subsidy whose amount rises directly with the tax rate, and, hence, the wealth of the testator. To illustrate: Consider two testators, A, who faces a 20 percent marginal tax rate, and B, who faces a 50 percent marginal tax rate. While A is able to reduce his tax bill by $20 in making a $100 bequest, B is able to reduce his tax bill by $50 in making the same sized bequest. Since the rate of subsidy rises with the testator's tax bracket, the charitable deduction confers benefits that increase with the wealth of the testator. Therefore, not only does the charitable deduction allow private testators to direct the expenditure of what may be regarded as public revenue, but also it allows relatively wealthy testators to exert disproportionately large influence concerning the use of such diverted revenue. Since the wealthiest 5 percent of all testators account for approximately two thirds of all deductions for charitable bequests, the preponderance of the implicit governmental subsidy to philanthropic institutions is given to those institutions selected by the wealthiest 5 percent of all testators.

Policy Alternatives to the Charitable Deduction

Those who feel that the charitable deduction is a form of governmental subsidy have suggested a variety of alternative policy options. Given the view that the charitable deduction is a type of tax expenditure, the choice among policy options will depend largely upon the view one adopts concerning the respective roles of the State and private philanthropy in the pursuit of charitable activity. One option is simply to eliminate the deductibility of charitable bequests. The best estimate of the consequences of such a policy change is that it would bring about at least a 50 percent reduction in the volume of charitable bequests.[6] Such an option might be applauded by those who feel that private philanthropy should be sharply curtailed, with responsibility for such activities being shifted even more fully into the public sector. By contrast, those who feel that private philanthropy should be maintained will search for policy options that will maintain charitable bequests, while avoiding those features of the charitable deduction that engender the hostility toward it. These policy options can be grouped into three classes: one class would contain options that maintain in modified form the deductibility of charitable bequests; a second class would substitute some form of tax credit for the charitable deduction; and the third class would introduce some program of governmental grants in place of the charitable deduction.

A Ceiling on Deductibility

It is sometimes suggested that the deductibility of charitable bequests be retained, but that a ceiling be placed on the amount that can be deducted.[7]

Fifty percent is a figure that has been bandied about more than any other figure. With such a ceiling, charitable bequests would still be deductible in determining taxable estate, but only so long as such bequests did not exceed 50 percent of gross estate. Bequests in excess of this ceiling would not be deductible under this option. Any such ceiling, by increasing the price to testators of making charitable bequests, would reduce the amount of such bequests. And the lower the ceiling, the greater the reduction in charitable bequests. A 50 percent ceiling, it is estimated by Boskin, would generate nearly a 10 percent reduction in charitable bequests.[8] Moreover, the estimated $189 million reduction in charitable bequests would be offset by only a $43 billion increase in tax revenues. Consequently, the primary effect of a 50 percent ceiling on the charitable deduction would be to increase the amount of bequests to private persons.

Support for ceilings rests primarily upon the feeling that no estate should escape tax liability altogether, even should the testator bequeath his entire estate to charity. This sentiment is analogous to that which supports the principle of a minimum income tax—the idea that no person should be able to escape liability for income tax, even though that person's income may indeed have been zero under the prevailing definition of income. To acknowledge that an analogy exists is not, of course, to provide a rationale for such provisions or sentiments, and such sentiments seem to be more appropriately consigned to the realm of irrational passion than to that of rational thought.

A related option that has been suggested on occasion is that a percentage limitation on the charitable deduction be applied only to bequests to private foundations—as distinct from bequests to public charities. Alternatively, limitations could be applied to both types of bequest, with a lower limit being applied on bequests to private foundations. Any such use of differential limits on the charitable deduction will promote a shift in the composition of philanthropic activity away from private foundations and toward public charities.[9] The primary rationale for this type of proposal must be that, at the margin, the social value per dollar of wealth flowing to public charities exceeds the social value per dollar of wealth flowing to private foundations. Less formally, concern is expressed that foundations are sometimes used by testators as devices to enable heirs to maintain control over their wealth, but without having to pay estate tax. At this point, however, the control issue essentially becomes one of the respective roles of government and private philanthropy in the support of philanthropic activities, which becomes largely a matter of assessing the performance of what might be called the "philanthropic industry." Some facets of this issue will be examined in Chapter III below.

A Tax Credit for Charitable Bequests

Instead of some modified form of deductibility, another policy option that has received considerable attention is the use of a tax credit. The rate of credit could be either fixed or variable, and could be set at any of numerous rates or rate structures. A fixed rate of credit would reduce estate tax liability by the product of the rate of credit and the amount of charitable bequest. With a 30 percent rate of credit, for instance, estate tax liability would fall by $30 for each $100 of charitable bequest. With a variable rate of credit, by contrast, the marginal rate of credit would vary with changes in circumstances such as the taxable wealth of the testator or the relative share of charitable bequests in the testator's gross estate.

A fixed rate of credit would be considerably less complex than a variable rate of credit, and yet would seem likely to command strong support from those who feel that private philanthropy should be maintained but who

Table 7

Charitable Gifts by Size of Total Gifts Before Splitting, 1965

(in millions of dollars)

Size of Total Gifts Before Splitting	Number of Returns	Total Gifts Before Splitting	Charitable Gifts Before Splitting		
			Number of Returns	Amount	Percent of Total Gifts Before Splitting
No total gifts before splitting	15,611	NA	NA	NA	NA
Under $50,000	82,247	$1,477	4,618	$ 59	4.0%
$50,000-under $100,000	10,339	697	1,177	45	6.5
$100,000-under $200,000	2,811	375	712	53	14.1
$200,000-under $500,000	1,213	360	485	76	21.1
$500,000-under $1 million	319	221	147	48	21.7
$1 million or more	256	832	164	244	29.3
Total	112,796	$3,963	7,303	$525	13.2%

Office of the Secretary of the Treasury
Office of Tax Analysis

May 29, 1974

Source: Tables 7 and 8, Statistics of Income, 1965.

believe that the present charitable deduction is a scheme that subsidizes especially heavily the charitable activities of the very wealthy. A fixed rate of credit establishes a constant price for charitable bequests, regardless of the wealth of the testator. This price is equal to one minus the rate of credit; a 30 percent rate of credit, for instance, yields a price of $0.70 per dollar of charitable bequest. Any such credit whose rate lay between the lowest and the highest marginal rates under the present rate schedule would discourage charitable bequests by those in the upper wealth brackets, and would encourage charitable bequests by those in the lower wealth brackets. A rate of 30 percent is the marginal tax rate applicable to the $100,000 to $250,000 taxable estate rate bracket. Hence, a 30 percent credit would discourage charitable bequests by those with more than $250,000 of taxable estate, while encouraging charitable bequests by those with taxable estates of under $100,000. Moreover, a 30 percent credit, it is estimated by Boskin, would generate nearly a 20 percent reduction in the total volume of charitable bequests.[10] Additionally, the resulting $360 million reduction in charitable bequests would be offset by only $227 million of increased tax collections, indicating that there would be an increase of $133 million in bequests to private persons.

There would exist, of course, some rate of credit that would leave the total volume of charitable bequests unchanged, though the relative importance of different testators in directing wealth to various charitable activities will have been altered.[11] The required rate of credit would be somewhat larger than the 30 percent rate analyzed by Boskin. Suppose, for purposes of discussion only, that the breakeven rate is 39 percent, which is the marginal tax rate applicable to taxable estates in the $1 million to $1.25 million bracket. Assuming that charitable bequests would be unchanged if the charitable deduction were replaced by a 39 percent credit, testators with estates below $1 million would increase their charitable bequests, while testators with estates above $1.25 million would reduce their charitable bequests.

A Matching Grant to Charitable Organizations

It has also been suggested that the charitable deduction could be replaced by a program of unconditional, matching grants to philanthropic institutions.[12] In principle, such a program of unconditional grants could be designed so as to achieve any desired volume of support for philanthropic institutions. For instance, consider Boskin's aforementioned estimate that the elimination of deductibility would reduce charitable bequests by approximately $1.1 billion, using 1969 data. Since the absolute value of the elasticity of demand for charitable bequests seems generally to exceed unity, a program of matching grants of something less than $1.1 billion would be sufficient to prevent a reduction in the amount of charitable bequests.

Although the proposal for a matching grant has received support as if it were a different proposal than a tax credit, there is essentially no difference between a tax credit and a matching grant. Any difference is mostly on the order of form, not of substance. A 30 percent credit means that tax liability is reduced by $30 per $100 of bequest, which means that a $70 bequest by the testator brings forth a $30 matching grant from the government. Therefore, a 30 percent credit is identical to a 43 percent matching grant. Under the 43 percent matching grant, a $70 charitable bequest would be matched by a $30 payment from the Treasury to the philanthropic institution designated by the testator.

There seem to be only two differences of any import between a tax credit and a matching grant. First, the matching grant would be administratively wasteful in comparison with the tax credit. To generate the same amount of charitable bequests under the matching grant would require that the government expend effort to determine the amount of bequests received by each charitable recipient, to compute the amount of matching funds to be received by each recipient, and then to prepare and send the checks. None of this effort would be required under a program of tax credits. Second, one of the historical lessons of the revenue sharing program has been that there is no such thing as an unconditional, matching grant. Some controls will always be placed on revenues that are spent through the government, and, moreover, there will always be demands expressed at various points in the political system for a strengthening of such controls.

In Support of the Charitable Deduction

The concern over the properties of alternative policy options for replacing the charitable deduction is predicated upon the belief that the charitable deduction is appropriately regarded as a governmental subsidy. There are strong grounds, however, for suggesting that the charitable deduction should not be viewed as a governmental subsidy.[13] The point of contention concerning whether the charitable deduction should be viewed as a governmental subsidy is easily illustrated. Consider three testators, A, B, and C. Let A and B each possess an estate of $1 million, and let C possess an estate of $500,000. Assume that A transfers his estate wholly to surviving members of the family, while B transfers $500,000 to surviving members and $500,000 to charitable institutions. Assume that C transfers his estate wholly to surviving members. The controversy over the charitable deduction, when viewed in this context, is one of whether B should be treated as an equal of A or as an equal of C. The view that the charitable deduction should be treated as a government subsidy implies that B should be treated as equal to A. The view that the charitable deduction should not be treated as a government subsidy implies that B should be treated as equal to C. The issue, then, reduces to one of choosing just who is to be treated as B's equal for purposes of taxation.[14]

The point of dispute regarding whether B should be treated as equal to A or as equal to C centers around the appropriate manner of conceptualizing charitable bequests and of drawing a distinction between charitable and noncharitable bequests. The thought patterns of many economists lead them to treat charitable bequests and contributions as ordinary, common acts of consumption. Such a perspective informs the literature on utility interdependence, for instance, and the popularity of this literature would seem to suggest that the conceptualization of charity as an act of personal consumption is conformable to the proclivities of many economists.[15] In making a choice of whether, and to whom, to make a charitable contribution or bequest, a donor must, by definition, choose his most preferred alternative. In this literature, a donor is viewed as choosing how to allocate his income or wealth between purchases for own consumption and purchases for the consumption of others, an allocation problem that is indistinguishable from the ordinary one of allocating one's budget among ordinary commodities. The "price" of charitable contributions is, quite simply, the amount of personal consumption that is foregone by virtue of making the contribution. An individual will expand his contribution to others so long as the marginal rate of substitution of contributions for own consumption exceeds the ratio of the price of contributions to the price of own consumption.

Consider two testators, D and E, each of whom bequeaths $500,000 to finance various vacation activities. In D's case, the bequest finances the purchase of a sumptuous summer home for members of the family. In E's case, the $500,000 is used to finance a program of summer vacation camps for inner-city youth. In both cases, according to the perspective that treats charitable bequests as consumption by the donor, the testator is giving up $500,000 and is receiving a "service" in exchange. It merely happens that in one case this service is a vacation for one's progeny, while in the other case it is the vicarious experiencing of vacations for strangers. Both patterns of bequest, then, would be regarded as instances of ordinary self-indulgence, with the only difference between the two being in the particular object of indulgence.[16]

A contrasting perspective would suggest that the deductibility of charitable bequests and contributions is fully appropriate as a matter of principle, and would be necessary for arriving at a definition of taxable income or wealth. Not only would the common perspective seem to obscure almost totally the distinction between "self-indulgence" and "self-denial," but also such a conceptualization would seem to violate all principles of scarcity in economics, for an economy, in producing more of this vicarious service, need not give up what the "producers" of this service could have produced otherwise. The consumption of a vacation by oneself uses up resources that would otherwise have been available for the use of others. One's vicarious experiencing of someone else's vacation, however, uses up no resources.

It seems clear that there is an economic aspect to all behavior, but this is not to say that all behavior is economic, or even that the economic motive is dominant in all behavior. Economic behavior, in this contrasting framework, is characterized by "non-tuism," as Wicksteed described it.[17] "Non-tuism" does not mean that there are discernable instances of pure, self-interested behavior which can be called "economic." Rather, it means only that there are instances in which a participant to a transaction does not take the interest of the other transactor into account in undertaking the transaction. Wicksteed gave the illustration of Paul making tents in Corinth. Paul's primary interest was to support his evangelical work, not to increase his wealth or consumption. Yet, so long as Paul, in selling his tents, does not allow himself to be influenced by the desires of purchasers for lower prices, the transaction between Paul and his customers is non-tuistic, or purely economic. It is only as Paul comes to let himself be influenced by his customers' desires for lower prices that tuistic elements emerge, in which case the transaction ceases to be purely economic.

Charitable contributions and bequests seem generally dominated by tuistic sentiments. It is precisely the taking into account to an overwhelming extent the interest of the *other person* that characterizes the charitable act. The physician who donates his services one day per week to a charity clinic is in the same position as Paul would have been had he allowed himself to be swayed by his customers' desires for lower prices. The situation is the same with the testator whose bequest finances a summer vacation camp for inner-city youth. Granted, there may be an economic aspect involved in selecting among subjects for contributions or bequests, but the economic aspect is distinctly of a second order of importance.[18] For the most part, however, our customs, laws, and institutions treat charitable activity as being outside the realm of profit-seeking activity, for tuistic sentiments dominate the former activity, but not the latter.[19]

When viewed from this perspective, two testators with equal wealth should not be subject to equal amounts of tax if one testator engages more heavily in making charitable bequests than the other. Rather, the person whose charitable bequests are larger should be regarded as having less wealth than the other person, so accordingly should pay less tax. Therefore, it would seem necessary to deduct charitable bequests in computing taxable estate. The aforementioned $500,000 bequest to finance summer vacations for inner-city youth should not be viewed as an act of consumption by the testator—as an act of self-indulgence—but should be viewed instead as analogous to a cost of acquiring income or disposing of an estate—as an act of self-denial. Therefore, the present tax treatment of charitable bequests, in which such bequests are fully deductible, would seem to be fully appropriate as a matter of principle.

The argument that the charitable deduction subsidizes especially the philanthropic activities of the wealthy would seem to be erroneous, once it is recognized that non-tuistic sentiments dominate charitable activity. Consider the previous illustration of three testators, A, B, and C. It is true that the charitable bequest reduces the tax liability of B by more than it would reduce the tax liability of C, should C make the same sized bequest. This effect, however, is due simply to the arithmetical consequences of progressive rates of tax and cannot be regarded as a subsidization of testator B. When the deductibility of charitable bequests is viewed as appropriate as a matter of principle, the empirical evidence regarding the impact of deductibility on charitable bequests is seen somewhat differently.[20] It is no longer a matter of using this evidence in order to construct a case for deductibility, for the case for deductibility exists independently of the empirical evidence. Rather, deductibility is an institution that induces the wealthy to divert an even larger portion of their wealth into publicly beneficial uses. That is, deductibility channels private motives into the provision of public goods.[21]

II

CONSTRUCTIVE REALIZATION OF CAPITAL GAINS UPON DEATH

Many commentators suggest that a major failure of our income tax system is the failure to tax capital appreciation, at least upon death, if not during life as well.[22] This position regarding capital appreciation stems from an acceptance of the Haig-Simons definition of income.[23] Under this definition, annual income is defined as the sum of annual consumption and changes in net worth over the year. Within this framework, unrealized appreciation is income, simply by definition, and that is all there is to the matter. While it is usually recognized that the annual taxation of capital appreciation is an ideal, it is also usually acknowledged that the delay of taxation until the asset is sold is an expedient alternative. It is in this vein that the income tax imposes a tax on capital appreciation only at the time that the appreciation is realized by the taxpayer, and then only at a rate that generally is one half the rate that would be charged against ordinary income.

Special issues arise when assets are held until death. Current tax practice is that no income tax liability is assessed against appreciated capital assets that are held until death. Moreover, the heir is able to take as his basis the fair market value of the assets at the time he takes possession. At the same time, a person can contribute appreciated assets to charity, and deduct the fair market value of such assets, even though the capital appreciation is never treated as taxable income in the first place. It has often been suggested that the decedent's final income tax return should reflect all capital appreciation. In this manner, capital appreciation at the time of death would be treated for tax purposes in the same manner as capital gains realized during life.

Presently, strong tax incentives exist for making contributions of appreciated assets. An appreciated asset carries an implicit tax liability, a liability that will become explicit if the appreciation is realized by the taxpayer. By donating the appreciated asset to charity, this implicit tax is avoided. Additionally, the taxpayer-donor is permitted to deduct the fair market value of the appreciated asset from his gross income in determining his taxable income. On both these accounts, then, the cost to a taxpayer of making charitable contributions of appreciated assets is reduced.

Consider a married couple filing a joint return, whose taxable income is $60,000. Since the marginal rate of tax at that income level is 50 percent, each $100 of appreciated assets that are contributed to charity will reduce the couple's tax liability by $50. Moreover, the capital appreciation, if ever realized, would be taxable at one half the marginal rate. As the share of the market value of the asset that is represented by capital appreciation increases, the implicit tax on the appreciation approaches $25 per $100 of asset value. Therefore, the cost to someone in the 50 percent rate bracket of making charitable contributions of appreciated assets can approach $25 per $100 of value transferred. The cost to the taxpayer of transferring appreciated assets would be even lower in marginal rate brackets above 50 percent (that is, in taxable income classes above $52,000 for married couples filing joint returns).

Present tax institutions give a clear advantage to a taxpayer who contributes appreciated property to charity over a taxpayer who first sells the assets and then contributes the same value in cash to charity. Consider, once again, a married couple filing a joint return. Let their taxable income be $50,000, and assume that they own appreciated assets which were initially purchased for $1,000, but which are now valued at $21,000. By donating these assets to charity, their taxable income falls to $29,000, which yields a tax liability of $7,490. Suppose, however, that the couple first sells the assets, and then transfers $21,000 to charity. Their taxable income would be $39,000 in this case,[24] which would carry a tax liability of $11,690. The couple's tax liability, then, can vary by $4,200, depending merely on the form in which the transfer is made. The incentive to make charitable contributions in the form of appreciated assets can be strong indeed.

The comparison that was made above was between a taxpayer who sells his assets first, then makes a charitable contribution, and a taxpayer who gives the assets directly to charity in the first place. This is the standard comparison in discussions of the tax treatment of gifts of appreciated assets. However, a quite different comparison could be made. This would be between a taxpayer who gives the assets directly to charity and a taxpayer who transfers the assets to his family via gift or bequest. This latter, intra-family transfer is also untaxed, and the tax treatment of charitable contributions of appreciated assets is currently treated the same as an intra-family transfer. Hence, a judgment about present rules regarding the transfer of appreciated assets depends on a choice of whether the appropriate basis of comparison is an intra-family transfer or a realization of the capital gain.[25]

The Treasury, in its 1969 proposals for tax revision, advocated that constructive realization be introduced into the income tax, except that transfers to charitable institutions would be exempt from tax. The introduction of constructive realization, by itself, would operate to reduce the size of estates because of the necessity of paying tax on the unrealized capital gains. However, if constructive realization were not applied to wealth bequeathed to philanthropic institutions, the price of such bequests relative to the price of bequests to individuals would be lowered, which would yield an incentive to transfer relatively more wealth to philanthropy. If, as I have argued elsewhere, the demand for bequests to heirs is price inelastic, while the demand for bequests to institutions is price elastic, the increased price due to constructive realization would lead to an increased expenditure on transfer to heirs, which implies a reduction in the amount left for charitable institutions.[26] Consequently, constructive realization, even with a charitable deduction, would seem likely to curtail charitable bequests, though not to the extent that would occur in the absence of a charitable deduction.

The view that capital appreciation should be taxed follows from the Haig-Simons definition of income. The Haig-Simons definition, however, does not command universal assent. Perhaps the most substantial conceptual weakness of this definition of income is that it confounds the important distinction between capital and income, between a service flow and the asset stock that generates that service flow. The more generally accepted definition of income has been expressed clearly by Irving Fisher, and yields quite different conclusions regarding the taxation of capital appreciation.[27]

Consider a person who owns an apple orchard containing 1,000 trees, with each tree yielding 500 apples annually. Thus, the stock of 1,000 trees produces an annual net yield of 500,000 apples, ignoring complications due to the necessity of arranging for the replacement of trees over time. Suppose the annual value of the yield of apples is $50,000. If the rate of interest is 10 percent, the value of the orchard will be $500,000. Taxation of the income flow at 20 percent annually would be equivalent to taxation of the capital value at 2 percent annually. Simultaneous taxation of the income flow and the capital value would, of course, double the rate of taxation.

Now suppose the price of apples doubles. The annual yield, in value terms, has risen to $100,000, which raises the market value of the orchard to $1,000,000. Under a system of income taxation, the higher value of the capital asset is reflected in the higher value of the annual yield from the asset. A failure to tax the capital appreciation is *not* a defect or loophole in a system of *income* taxation. The capital gain of $500,000 should not be taxed, simply because it is not income. The rise in capital value is reflected in the larger income flow, and in a system of income taxation, it is on the income flow that the tax should be levied. The $500,000 increase in capital value is simply incidental to the $50,000 increase in annual net income. The capital gain is nothing but the capitalization of the increased income flow. To tax both the income flow at its larger rate and the gain in capital value is to engage in a double counting that totally confounds the fundamental distinction between a flow of produced services and the stocks of assets that produce those services. It would seem that not only is the constructive realization of capital gains something that should not be implemented, but also the present income tax treatment of capital gains is something that should be eliminated.[28]

III

THE STATE AND THE SUPPORT OF PRIVATE PHILANTHROPY

This section will explore various issues relating to the appropriate roles of government and private philanthropic institutions in undertaking charitable activities. It will examine some of the insights that economic analysis can generate concerning the social organization of philanthropic activity. The discussion in this section touches upon, in several respects, the tax treatment of charitable bequests. The discussion is also related to the aforementioned point about the possible differentiation between private foundations and public charities, as well as to some related, more general issues concerning the appropriate role of the state in regulating the activities of private philanthropic institutions.

As has been noted above, some recent efforts by economists have attempted to explain philanthropic activity within a utilitarian frame of reference. Within this context, a gift from one person to another is "explained" as an activity in which the donor gives money or specific services to the donee, and receives from the donee an equivalent service in exchange. This latter service is some intangible service that yields the donor a psychic return, and which can be produced by the donor without employing scarce resources in its production. Hence, gifts are treated as consumption by the donor.

Within this utilitarian framework regarding charitable bequests and contributions, the next step in the reasoning is a suggestion to the effect that private contributions will be inefficiently small. Individual donors will be caught in the familiar free-rider dilemma. Each individual will recognize that his donation will do little to alleviate the total volume of suffering; consequently, such persons will not contribute, and less suffering will be alleviated than the participants, taken collectively, would prefer to see alleviated. This line of argument supports an increase in the public role in philanthropic activities, the reason being that such activities possess characteristics of public goods.

When viewed in terms of the utilitarian-public goods perspective, the issue of whether our society should expand the relative importance of government might be answered affirmatively. This suggestion, however, is not a necessary consequence of the utilitarian framework per se. Rather, it follows from the presumption that the return to the donor is a function of the relative alleviation of total suffering. In Western civilization, there is a long-standing, well-entrenched sense of obligation or duty on the part of those who are relatively fortunate to assist those who are relatively unfortunate. In this case the return to the donor inheres in the act of giving, not in the results of giving, and the standard public-goods case for the collectivization of charity becomes invalid.[29] Empirical evidence relevant to this point has been developed by Feldstein and Clotfelter.[30] They tested the hypothesis that the amount of a person's charitable contributions was dependent on the amount of contributions made by his fellows, and found it necessary to reject this hypothesis of interdependence. Consequently, it would seem, at least tentatively, that we should regard the donor's return to charitable giving as inhering in the act of giving itself, not in the results of giving. Therefore, there would be no case based on market failure, at least at prevailing margins of choice, for an expansion in the relative importance of the collective provision of charitable activities.

Additionally, the comparative properties of encouraging private philanthropy and of promoting greater government responsibility is related to several perspectives in the recently emerging theory of government, bureaucracy, and property rights that is being developed primarily by economists.[31] It is often claimed that private philanthropy should be supplemented by government action, whenever private philanthropy fails to fulfill its responsibilities. Such a statement, however, does not imply that an observed budgetary decision to expand public spending on certain forms of philanthropic activity is evidence that private philanthropy has proven ineffective. Rather, it means only that majority consent has been found for that particular spending program, which is a statement with a quite different epistemological content.[32]

One of the primary features of the Tax Reform Act of 1969 was the distinction that was drawn between private foundations and public charities, and the imposition of special taxes and regulations on private foundations. A 4 percent excise tax was imposed on the net investment income of foundations. Foundations were also subject to a minimum distribution requirement, equal to the larger of a foundation's net income and 6 percent of its assets.[33] A limit was placed on the amount of ownership interest in a firm that could be held by a foundation and related parties; this limit was set at 20 percent of the voting stock in a corporation, unless the foundation itself held less than 2 percent. A 50 percent limit was placed on the deductibility of appreciated assets given to foundations, though no such limit was placed on appreciated assets given to public charities. The income tax limitation on deductibility became 20 percent on gifts to foundations, but 50 percent on gifts to public charities. While no such distinction currently exists in the estate tax, several suggestions have been advanced for the incorporation of such a distinction. Moreover, it was proposed, but never enacted, that foundations be subject to a maximum life span of 40 years.

There are reasons related to the aforementioned economic analysis on bureaucracy and property rights for suggesting that there are some substantial differences between foundations and public charities. Although foundations and public charities have similar patterns of ownership, they differ in the conditions governing survivability which they confront. For both sets of institutions, the directors or the trustees may be regarded as the owners. The customers of any particular philanthropic institution are the donors, who, with their contributions and bequests, finance the services that are dispensed to clients. A public charity, in order to survive, must continually convince customers-donors that its activities are sufficiently worthwhile to merit the customer's donation.[34] By contrast, a private foundation can survive without attracting new customers. Once a foundation has been created, its survival is hardly threatened, save for disastrous investment policies.[35] That is, a foundation's granting activities, unlike those of a public charity, need not be such as to elicit future contributions in order to survive.

Some empirical evidence suggesting that organizational performance is likely to become poorer as the link between performance and survival is weakened is beginning to accumulate.[36] In this respect it is noteworthy that in 1968 the average rate of return on foundation assets was 5.6 percent, whereas the average rate of return on mutual funds was 15.3 percent for common stock funds and 14.9 percent for balanced funds.[37] Given that foundation assets are between $20 and $30 billion, the annual income that seems to be lost by poor investment performance is in the vicinity of $2 to $3 billion annually, a figure that is about equal to the annual amount of foundation giving.[38]

While private foundations are organized such that efficiency pressures are blunted, the consequences of the 1969 tax revision do not seem wholly desirable. Ideally, what would seem desirable would be a situation in which it would be necessary for foundations to compete to attract customers-donors in order to survive, but without curtailing the supply of capital made available to foundations. There is reasonable evidence that one consequence of the 1969 tax revision has been to discourage capital formation in foundations. Not only the provisions dealing with gifts of appreciated property, but also the restrictions on the ownership of corporate stock reduce the attractiveness of placing capital in foundations. Moreover, the regulatory and legal complexity of operating a foundation has been increased.[39]

It might be desirable to consider an institutional framework in which a foundation would disappear after a certain number of years, if it failed to attract additional capital. Some time period such as 20 years could be selected. If a 20-year period were selected, a foundation would be required to pay out one twentieth of its principle each year, in addition to interest earnings and capital appreciation. A foundation that attracted no new donations would disappear after 20 years, or after whatever other period was selected. This required rollover of foundation capital could take the form of a tax on foundations, with a deduction allowed for a foundation's grants.[40]

As a result of such a program, a foundation could survive indefinitely, but only by convincing customers-donors to "buy" its product by making donations and bequests. At the same time, however, it would be important to avoid drying up the supply of capital to foundations, which is one of the dangers of the Tax Reform Act of 1969. To this effect, most of the particular

1969 provisions could profitably be repealed, as they have the effect more on the order of restricting the supply of capital to foundations than of increasing the operation of competitive forces confronting foundations. Certainly the provisions regarding excess business holdings, as well as the discrimination against foundations with regard to contributions of appreciated property, fall into this category, and could be repealed with profit. The tax on net investment income, in conjunction with the minimum distribution requirement, could be reformulated so as to establish the necessary competitive environment that was described in the preceding paragraph.

IV

CONCLUDING SUMMARY

In this paper I have examined three main issues regarding the tax treatment of charitable bequests. I first addressed the charge that the charitable deduction is a device for subsidizing the charitable activities of the wealthy. If such a view is accepted, policies such as ceilings on charitable deductions, tax credits, and matching grants become alternative policy options for generating a different pattern of subsidy. By contrast, if such a view is not accepted—if the charitable deduction is not considered to be a tax expenditure—no issues arise concerning the appropriateness of the charitable deduction. Both perspectives were explored, and an explanation was made of what is at stake in making a selection among perspectives. It would seem that generally there is little basis for considering charitable bequests and contributions as a form of consumption to the donor. It seems more reasonable to view such donations as sacrifices of potential consumption, in which event the charitable deduction becomes fully appropriate as a matter of principle. That the charitable deduction has the effect of stimulating contributions and bequests, in this view, does not provide a justification for this institution, but rather provides reinforcement for an institution that is appropriate as a matter of principle.

I then examined the treatment of unrealized appreciation on capital assets. A prominent proposal has been to incorporate all unrealized appreciation into the final income tax return of the decedent. With respect to proposals for taxing unrealized appreciation, it was shown that one's attitude depends on whether one accepts the Haig-Simons definition of income or the Fisher definition. The latter definition not only is more consistent with the underlying framework of economic analysis, but also suggests that unrealized appreciation should not be subject to personal income taxation.

I concluded with a consideration of some matters relating to the public regulation of philanthropic activity. To a considerable extent, the conclusions were agnostic, as there currently is little in the way of economic analysis of the functioning of the "philanthropic industry" upon which to draw. Some suggestions were made regarding the differential treatment of private foundations and public charities. It was suggested that there are reasons for suspecting that foundations will perform poorly relative to public charities, though the specific changes made by the 1969 tax revision act confounded considerations relating to the competitive environment within which foundations operate and considerations relating to the supply of capital to foundations. Some suggestions were made as to how these two separate considerations might be disentangled, so as to maintain a supply of capital to foundations and yet create a closer link between foundation performance and foundation survival.

Footnotes

1 Estate and gift tax collections by the national government amounted to $4.6 billion for fiscal 1973, and are estimated to amount to $5 billion for fiscal 1974. See *The Budget of the United States Government, Fiscal Year 1975* (Washington: U.S. Government Printing Office, 1974).

2 For recent, general considerations of taxation upon death, see Carl S. Shoup, *Federal Estate and Gift Taxes* (Washington: The Brookings Institution, 1966), and Richard E. Wagner, *Death and Taxes: Some Perspectives on Inheritance, Inequality, and Progressive Taxation* (Washington: American Enterprise Institute, 1973).

3 About 45 percent of charitable bequests are bequeathed to public charities, and about 55 percent are bequeathed to private foundations.

4 In this essay it is taken for granted that the State will impose a tax upon decedent's estates, and the discussion will focus upon alternative issues and policy options regarding the tax treatment of charitable bequests within such a system of taxation. There are, of course, alternative ways of taxing wealth transferred upon death, and the treatment one might want to accord to charitable bequests may vary with the particular tax form that is used. While the national government, and some state governments, levy the tax upon the estate of the decedent, most states levy the tax upon the *inheritance* of the heirs, and the choice between estate taxation and inheritance taxation may influence one's perspective on some of the issues addressed in this paper. Moreover, it has sometimes been suggested that the separate taxation of estates and gifts be abolished, with the receipt of wealth via gift or bequest either being incorporated into the personal income tax or being replaced by a unified tax on transfer receipts — an accessions tax. Once again, the choice among these tax forms may influence one's perspective on some of the issues to be addressed in this essay. This is an essay on alternative treatments of certain transactions within a given tax system, however, and not an essay on alternative tax systems, so the discussion shall focus on estate taxation.

5 The actual tax burden under existing rates would be $325,700, but the various arithmetic examples used in this paper are based on round numbers because of their illustrative convenience.

6 Michael J. Boskin, "Estate Taxation and Charitable Bequests," paper prepared for the Commission on Private Philanthropy and Public Needs.

7 Such ceilings are part of the income tax treatment of charitable contributions.

8 Boskin, op. cit.

9 The personal income tax currently imposes such a differential limitation, the ceiling being 20 percent on contributions to private foundations and 50 percent on contributions to public charities.

10 Boskin, op. cit.

11 Such a rate of credit as a replacement for deductibility in the personal income tax is estimated to be 28 percent. See George F. Break, "Charitable Contributions Under the Federal Individual Income Tax: Some Alternative Treatments," paper prepared for the Commission on Private Philanthropy and Pubic Needs.

12 See, for instance, Paul R. McDaniel, "An Alternative to the Federal Income Tax Deduction in Support of Private Philanthropy," in *Tax Impacts on Philanthropy* (Princeton: Tax Institute of America, 1972), pp. 171-209.

13 See, for instance, William D. Andrews, "Personal Deductions in an Ideal Income Tax," *Harvard Law Review*, 86 (December 1972) 309-85; and Boris I. Bittker, "The Property and Vitality of a Federal Income Tax Deduction for Private Philanthropy," in *Tax Impacts on Philanthropy* (Princeton: Tax Institute of America, 1972), pp. 145-70.

14 Should death taxation take the form of taxing the inheritances of heirs rather than the estates of decedents, it seems clear that the estate of B, as it devolved to heirs, would be treated as equal to that of C rather than to that of A. This point is seen most clearly if it is assumed that

each estate devolves upon a single heir. The devolution of A's estate would generate $1 million for the heir, but the devolution of B's and C's estates would each generate only $500,000 for the respective heirs. The only difference between B and C is that in the case of B's estate there is also a $500,000 bequest to philanthropic institutions. However, given the prevailing tax treatment of nonprofit, philanthropic institutions, this part of B's bequest would generally be exempt from tax. Consequently, when viewed from the perspective of an inheritance tax, B's estate would be considered the equal of C's estate, not of A's estate, thereby making a charitable deduction necessary for arriving at an appropriate definition of taxable estate.

15. See, for instance, Harold M. Hochman and James D. Rodgers, "Pareto Optimal Redistribution," *American Economic Review*, 59 (September 1969) 542-57.

16. As Bittker notes, this frame of analysis "requires gifts to charities to be classed with wine, women, and song." Boris I. Bittker, "Charitable Contributions: Tax Deductions or Matching Grants?" *Tax Law Review*, 28 (Fall 1972) 47.

17. See Philip H. Wicksteed, *The Common Sense of Political Economy* (London: Macmillan, 1925), pp. 173-77, for a characterization of economic behavior in terms of the predominance of non-tuistic sentiments.

18. This may not be the case for the establishment of private foundations in certain instances, where such factors as the provision of security for heirs may be an influential element.

19. This point is developed forcefully in Bittker, "The Propriety and Vitality of a Federal Income Tax Deduction for Private Philanthropy," op. cit.

20. Recall that Boskin estimated that the deductibility of charitable bequests induces the wealthy to make about twice the charitable bequests that they would have made in the absence of deductibility.

21. C. M. Lindsay, "Two Theories of Tax Deductibility," *National Tax Journal*, 25 (March 1972) 43-52, develops two reasons for deductibility, the second of which conforms to this interpretation of the charitable bequest deduction.

22. See, for instance, Jerome Kurtz and Stanley S. Surrey, "Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal," *Columbia Law Review*, 70 (December 1970) 1365-1401.

23. A statement and defense of this concept of income is contained in Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938).

24. The taxable income is equal to the annual income of $50,000, plus one half of the capital gain of $20,000, less the charitable deduction of $21,000.

25. For a discussion of this point, see Bittker, "The Propriety and Vitality of a Federal Income Tax Deduction for Private Philanthropy," op. cit., pp. 169-70, and "Charitable Contributions: Tax Deductions or Matching Grants?" op. cit., p. 63.

26. Richard E. Wagner, *Death and Taxes*, pp. 23-28. Boskin, op. cit., generally found that the demand for bequests to charitable institutions was quite price elastic.

27. See particularly, Irving Fisher, *The Theory of Interest* (New York: Macmillan, 1930). For a recent discussion of this confounding of capital and income that is epitomized in proposals to tax capital appreciation as income, see Dan T. Smith, "Capital Gains, Losses in Income Taxation," *Tax Review*, 33 (December 1972) 45-48.

28. Admittedly, this statement regarding the nontaxation of capital gains is something that would be tempered by certain pragmatic considerations, for pragmatic implementation is not so simple as the aforementioned conceptual illustration may suggest. The tax treatment of owner-occupied housing serves as a good example. The flow of services from such housing is not taxed as income, while capital gains on sales of residences are taxed, though many countries do tax the imputed income of owner-occupied housing. Similarly, common stocks may yield no dividends, while appreciating in value nonetheless. In many respects, the replacement of our system of

personal income taxation with one of consumption taxation would have much to commend it, for consumption is a more accurate indicator of permanent income on the one hand, and would avoid such problems as that illustrated by the appreciation of common stock on the other hand.

29. See Boris Bittker, "Charitable Contributions: Tax Deductions or Matching Grants?" op. cit., pp. 56-62, for a development of the point that charitable contributions are largely regarded as the discharge of a moral obligation, as a relinquishing of what wasn't one's in the first place, rather than as an act of consumption. See also, Thomas R. Ireland, "Charity Budgeting," in Gordon Tullock, ed., *The Economics of Charity* (Blacksburg, Va.: Center for Study of Public Choice, 1970), pp. 24-25, for a development of the point that the return to the donor from an act of giving inheres in the act of giving, and is not dependent on the results of giving.

30. Martin S. Feldstein and Charles T. Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Microeconometric Analysis," paper prepared for the Commission on Private Philanthropy and Public Needs.

31. For a small sample of works, see Armen A. Alchian, "Some Economics of Property Rights," *Il Politico*, 30 (December 1965) 816-29; Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review*, 62 (December 1972) 777-95; Robert J. Barro, "The Control of Politicians: An Economic Model," *Public Choice*, 14 (Spring 1973) 19-42; Albert Breton, *An Economic Theory of Representative Government* (Chicago: Aldine, 1972); and Robert M. Spann, "Public Versus Private Provision of Governmental Services," in Thomas E. Borcherding, ed., *Budgets and Bureaucrats* (Durham: Duke University Press, 1974).

32. See Richard E. Wagner, "Politics, Bureaucracy, and Budgetary Choice: The Brookings Budget for 1974," *Journal of Money, Credit and Banking*, 6 (August 1974) 367-83, for an analysis and examination of this point as it pertains to the interpretation of some particular programs of public expenditure.

33. The required rate is actually a variable to be determined by the Secretary of the Treasury, but the initial rate was set at 6 percent.

34. The properties of such competition among charities for donor support are not yet well understood, particularly in relation to such matters as the relative amounts of a charitable organization's budget that is devoted to soliciting funds, and of the information system governing the relation between a charity's objective performance and the donor's subjective impression of that charity's performance. These issues are raised in Gordon Tullock, "Information Without Profit," *Public Choice*, 1 (Fall 1966) 141-59.

35. This characteristic of foundations is noted in Kenneth E. Boulding, "Notes on a Theory of Philanthropy," in Frank G. Dickinson, ed., *Philanthropy and Public Policy* (New York: National Bureau of Economic Research, 1962), p. 66.

36. See, for instance, Roger Ahlbrandt, "Efficiency in the Provision of Fire Services," *Public Choice*, 16 (Fall 1973) 1-16; David G. Davies, "The Efficiency of Public Versus Private Firms: The Case of Australia's Two Airlines," *Journal of Law and Economics*, 14 (April 1971) 149-65; and Alfred Nicols, "Stock Versus Mutual Savings and Loan Associations: Some Evidence of Differences in Behavior," *American Economic Review*, Proceedings, 57 (May 1967) 337-46.

37. The Commission on Foundations and Private Philanthropy, *Foundations, Private Giving, and Public Policy* (Chicago: University of Chicago Press, 1970), pp. 74-75.

38. As further evidence on inefficiency in foundation management, the annual rate of turnover of foundation portfolios averages 1 to 2 percent, which is about one tenth the turnover rate on mutual funds. Ibid., p. 75.

39. For some empirical evidence on these matters, see Council on Foundations, Inc., *Report and Recommendations on Private Philanthropic Foundations*, paper prepared for the Commission on Private Philanthropy and Public Needs, pp. 1623-25.

40. For some suggestions along these lines, see Richard A. Posner, *Economic Analysis of Law* (Boston: Little, Brown & Co., 1972), pp. 248-49.

PROPOSED LIMITATIONS ON THE ESTATE TAX DEDUCTION FOR CHARITABLE TRANSFERS

David Westfall [†]

Introduction

Justification for the present unlimited estate tax deduction for charitable transfers under §2055 of the Internal Revenue Code usually is sought from one or more of the following sources:

1. Charitable transfers remove burdens from the federal Treasury by performing governmental functions;
2. Charitable transfers perform functions which benefit the general public even though they probably would not otherwise be undertaken by government;
3. Fairness to the transferor (or, more realistically, his beneficiaries) requires that the part of the estate that is devoted to the performance of functions that are either governmental or of benefit to the general public not be included in the measure of the estate tax;
4. The unlimited deduction is an important incentive which stimulates the making of charitable gifts which would not otherwise be made. It thus secures for governmental or public purposes amounts equal to or greater than the reduction in estate tax revenues which it costs.

It is appropriate to analyze each asserted justification to determine whether, and to what extent, it is valid, as well as whether it is consistent with any limitations that might be placed on the deduction.

I

PERFORMANCE OF GOVERNMENTAL FUNCTIONS

It is often asserted that charities perform governmental functions. To the extent a transferor has undertaken to make his wealth available for such purposes, he already has achieved two major objectives often attributed to the estate tax: (1) raising revenue for public purposes, and (2) redistributing wealth. To some extent, charitable transfers may in fact perform governmental functions. Perhaps the clearest example would be a devise to the United States of land that was scheduled to be taken by the United States for public purposes in eminent domain proceedings. In this case, the devise might reasonably be expected to release public funds otherwise required to pay compensation to the landowner, so that they would be available for other purposes. Similarly, a bequest may be made to an organization which gives money to individuals who would otherwise be eligible and apply for some kind of federally financed public assistance. Although here the effect of the bequest in releasing public funds for other purposes is less direct and immediate than the effect of the devise of land just described, the making of the bequest likewise has a tendency to lighten demands on the federal fisc.

It is submitted, however, that the examples just given are by no means representative of the bulk of charitable transfers, which often have no such direct effect in releasing federal funds for other purposes. A prime illustration is provided by transfers to religious organizations. In view of constitutional inhibitions on direct federal assistance to such organizations, it does not appear that such transfers operate directly to release federal funds for other purposes. And even though religious bodies can and do themselves perform governmental functions, such as education, such functions often are the primary responsibility of state or local governments. In that case, the relief provided the federal fisc by a transfer to a religious body is limited to the effect of such transfers on the level of federal aid to education or federal revenue sharing. Surely such an effect is too uncertain to provide substantial support for an unlimited charitable deduction.

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Other transfers for charitable purposes may lead to expenditures which Congress legally could make but has in fact shown no disposition to undertake. Although such transfers may serve significant purposes, they cannot provide justification for the charitable deduction as a means of removing burdens from the federal Treasury, as there is no reason to believe the burden would lie there if the particular charitable transfer were not made. Such justification, if it is to be found from such transfers, must stem from their performance of functions which are important to the public even though they would not be undertaken by government in the absence of a charitable transfer for the particular purpose.

II

PERFORMANCE OF PUBLIC FUNCTIONS THAT GOVERNMENT WOULD NOT UNDERTAKE

Many charitable transfers unquestionably do perform functions that the federal government could not reasonably be expected to undertake. The realities of the legislative process and majoritarian control of public expenditures, as well as the reluctance of many administrators to authorize expenditures for novel or controversial purposes, operate to constrict the range of projects for which federal funds are available. Charities often are relatively free from such constraints and may undertake projects of major benefit to the general public which would not otherwise be governmentally financed.

Indeed, it is probable—although by no means demonstrable in any quantifiable terms—that charities spend much more on functions that the federal government would not otherwise undertake than on functions that serve as a substitute for federal expenditures and thus relieve the Treasury. But from this it does not follow that the present unlimited federal estate tax deduction for charitable transfers is justified in its present form. It is still necessary to determine whether the unlimited deduction is required, either by considerations of fairness or as an incentive to insure that charitable transfers will continue to be made.

Furthermore, it must be borne in mind that the fact that a given charitable expenditure would not otherwise be made by the federal government does not automatically guarantee that it is a desirable use of wealth from the standpoint of the general public. It is by no means impossible for transferors to allocate funds for charitable purposes which would be given a low priority by most objective observers. While it is true that the list of permissible charitable purposes has been specified in the Code, it encompasses an extremely broad range of objects. The choice of object thus depends on the personal preferences of the transferor, rather than on what is needed most by the general public.

III

FAIRNESS TO TRANSFERORS (OR THEIR BENEFICIARIES)

The unlimited estate tax charitable deduction is sometimes said to be required by considerations of fairness to transferors. If the charitable transfer performs functions which relieve the government of its burdens or which benefit the general public, it is said to be unfair to include the transfer in the measure of the estate tax. It is sometimes reasoned that the transferor cannot derive any personal benefit from the charitable transfer because he is dead when it takes effect. Of course this reasoning is equally applicable to his noncharitable transfers. In each case, however, the transferor does have the satisfaction of knowing that his wealth will go after his death to the organization or individual that he has chosen to receive it. If that satisfaction did not have importance to him, he would be unlikely to make the particular gift in question, whether it is for a charitable or a noncharitable purpose.

Realistically, of course, the question of fairness must be viewed from the perspective of the transferor's beneficiaries, rather than the transferor himself, as by definition it is their enjoyment of wealth rather than his which is affected by the taxation of his transfers. If it were possible to identify in individual cases those instances in which a charitable transfer in fact removed burdens from the federal Treasury by performing governmental functions which it would otherwise finance, reduction in the taxes borne by the beneficiaries of the estate would seem to be no more than fair. No such case-by-case determination is feasible or appropriate, however. And arguments based on fairness are less compelling in the case of charitable transfers which do not similarly relieve the federal Treasury, but which instead may merely reflect the personal preferences of the transferor. Thus although there are doubtless individual instances in which fairness would seem to make a deduction for charitable transfers appropriate, the difficulty in distinguishing those cases makes it preferable to structure the deduction instead as a tax incentive for charitable transfers.

IV

INCENTIVE EFFECTS

A major argument for some kind of deduction for charitable transfers is that the deduction stimulates the making of charitable gifts which would not otherwise be made. If, however, the deduction is to be justified primarily as an incentive, it becomes necessary to make some judgment as to its effectiveness in terms of the volume of transfers which it calls forth which would not otherwise be made. I am not aware of any convincing evidence that the estate tax deduction generates a flood of gifts that would not otherwise be made. The subject is analyzed extensively in McNees, "Deductibility of Charitable Bequests,"[1] but the analysis necessarily rests on interferences which can be drawn from the relationship between various characteristics of transferors, their estates, their beneficiaries, and the level of their charitable gifts.

McNees concludes that the deduction has a sizable incentive effect for large estates, but that "[f]or the non-millionaire estates taken by themselves, no statistically significant incentive effect could be isolated."[2]

Of course there is no way to verify what particular transferors would do with their wealth if the charitable deduction did not exist in its present form. Although studies such as that of McNees are extremely useful, they need to be supplemented by individual observations based on familiarity with the motivations and responses of transferors in disposing of their wealth.

In making such observations, it is useful to consider the cases of six hypothetical transferors and attempt to make some judgment as to the extent to which each is representative of a significant number in real life. The cases are as follows:

Case 1. "I would like to leave something for my family, but the charitable deduction is so attractive that I will cut my family out completely and leave everything to charity."

Case 2. "I would like to leave $1 million to my family, but the charitable deduction is so attractive that I will cut that down to $500,000 and they will have to get along on less so that I can give more to charity."

Case 3. "I am leaving $1 million to my family, which is enough to take care of them. After taxes are paid on this amount, I have money left over which I could either (a) add to what I leave to my family, or (b) give to more distant relatives or to friends, or (c) give to charity. Because of the charitable deduction, I will give it to charity instead of to my family, more distant relatives, or friends."

Case 4. "I really don't want to give anything to my alma mater, but since I can get a charitable deduction for estate tax purposes, I will bequeath $5,000 to Siwash College."

Case 5. "I am leaving $1 million to my family, which is enough to take care of them. After taxes are paid on this amount, I have money left over which I want to leave to charity, whether or not it saves me taxes, because giving to charity is more important to me than any of the alternatives described in Case 3."

Case 6. "I would like to leave $5,000 to my alma mater whether or not I can get a charitable deduction for doing so."

In Cases 1, 2, 3, and 4, the charitable deduction is a significant incentive which induces the making of charitable transfers which would not be made in its absence. In Cases 5 and 6, on the other hand, the deduction does not influence the amount transferred to charity. To whatever extent they describe transferors in real life, the charitable deduction is wasted from the standpoint of an incentive effect.

Individual judgments will differ as to the frequency of each of the cases in real life. My own impression is that Cases 1 and 4 are extreme illustrations which occur so infrequently as to be unimportant in structuring the deduction and that Case 2 is almost equally rare; the great bulk of transferors seem to fit Cases 3, 5, and 6, or some combination thereof. Undoubtedly a large number fit no single stereotype but instead are influenced by the deduction but not to the exclusion of all other considerations. If that view is correct, the deduction does have an important incentive effect but one which does not justify its present unlimited form.

Again it is a matter of individual judgment, but my own impression is that Case 3 is much less common than is generally believed. Although it is true that many transferors say that they are motivated by the deduction to give to charity in preference to noncharitable beneficiaries, what people believe influences their behavior and what in fact does so are often two different things.[3] We do know that substantial charitable gifts were made before the enactment of the present estate tax and continued to be made after its enactment during years when the rates were quite low by present standards. This is rather conclusive evidence that the incentive provided by the present unlimited deduction is unnecessary in the case of many transferors, who would make substantial gifts even if there were no deduction or only a more limited deduction.

To reduce this loss of public revenues, the estate tax charitable deduction should be limited in such a way as to deny it for those charitable transfers which would be made in any case and to concentrate its effect where it is most likely to lead to additional charitable gifts. In my view, the incentive is most likely to be significant in estates in which charitable gifts are a substantial part but not the entire estate—Cases 2 and 3 above. If the entire estate goes to charity, the testator would appear to be relatively uninterested in other potential beneficiaries, so that the deduction is not needed as an incentive. On the other hand, if only minor charitable gifts are made, the motivation often has nothing to do with taxes—a desire to confer a token benefit on the testator's alma mater or his church, for example.

Under this analysis, it would be appropriate to impose both a ceiling and a floor on the deduction. Charitable gifts up to 10 percent of the estate, for example, could be disregarded, as could gifts in excess of 50 percent of the estate; in each case, the estate could be computed after deduction of the marital deduction. These limitations would confine the deduction to those estates in which there is some reason to believe that the testator may be weighing the desire to give to charity against his desire to make additional provisions for other beneficiaries. If the decision is marginal, the deduction may carry the day for charity.

From an incentive standpoint, the case seems particularly strong for a 10 percent floor on the deduction. It has been estimated that such a provision would increase tax revenues by $100 million "at a cost of reducing total charitable bequests by $60 million as an absolute maximum and probably some figure substantially below that."[4]

The same source provides less support, from an incentive standpoint, for a ceiling on the deduction than for a floor. The incentive effect is seen as significant for millionaire estates and it is estimated that a 50 percent ceiling "might very well reduce contributions by more than $200 million."[5] Even if, as is suggested by McNees, the reduction in bequests approached the amount of reduction resulting from the imposition of the ceiling in the subsidy to charity which the deduction now provides, there are other justifications for the ceiling. It would limit the extent to which some transferors now avoid all estate taxes and thus control the allocation of their entire wealth, while for others such control is limited by estate taxes. Granted that there are substantial benefits from charitable giving, they do not seem so compelling as to justify allowing some large estates to escape taxation altogether.

It has been suggested that placing a floor and a ceiling on the charitable deduction may have a greater impact on the level of charitable giving than the figures referred to above would indicate. A floor might conceivably discourage the making of small bequests which, in time, would be changed in later revisions of the testator's will into gifts of more substantial sums. However, as is suggested above, it seems unlikely that small bequests are primarily deduction-motivated in most cases anyway. With respect to the ceiling, it has been suggested that testators might view it as reflecting congressional disapproval of larger charitable gifts, so that a testator who wished to bequeath his entire estate to charity even though only 50 percent would qualify for the deduction would be deterred from bequeathing more—not because of tax considerations but because of deference to the policy embodied in the 50 percent limitation. Although it is impossible to generalize about the reactions of individual testators, the response just described does not seem plausible in most cases. Certainly the experience with a 50 percent limitation on the marital deduction offers no support for the view that testators who want to bequeath more than 50 percent of their estates to their spouses are inhibited from doing so because of an inference of congressional disapproval of excessive spousal bequests.

McNees suggests as an alternative to the present deduction, a credit against the tax. This would provide an incentive for charitable gifts which would not be affected by the marginal estate tax bracket. For each dollar transferred to charity, a fixed percentage—McNees suggests 40 percent—would be credited against the federal estate tax. This approach would have the advantage of equalizing the benefits of charitable giving in large and small estates, instead of the present situation in which each dollar given to charity produces a substantially larger benefit in a $1 million estate than in a $100 thousand estate. However, if McNees' conclusion that the incentive is more important in estates over $1 million is correct, the shift to a credit instead of a deduction is not an effective way to produce the incentive where it is needed most.

Although limitations on the estate tax charitable deduction may reduce the incentive for death-time transfers to charity, it should be noted that such proposed limitations would also make lifetime transfers to charity relatively more attractive. Some testators who now prefer to do the bulk of their charitable giving when they die might prefer to avoid the limitations by making larger gifts during life, with the result that charities would benefit from such gifts sooner than would otherwise be the case.

Consideration of the appropriateness of the present gift tax and income tax treatment of lifetime transfers to charity is outside the scope of this paper. It appears reasonable to assume, however, that tax incentives are more important in connection with lifetime gifts than with transfers at death, in order to induce the donor to forego the enjoyment of the wealth himself, or of control over it, while he lives.

Footnotes

1. McNees, "Deductibility of Charitable Bequests," 26 *National Tax Journal* (1973), 79.

2. Ibid, p. 84.

3. See Break, "The Effects of Taxation on Work Incentives," Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability* (1955), 192.

4. McNees, op. cit., p. 94.

5. Ibid., p. 95.

Part V

Alternatives to Tax Incentives

ALTERNATIVE APPROACHES TO ENCOURAGING PHILANTHROPIC ACTIVITIES

Gerard M. Brannon† and James Strnad*

Introduction

The charitable contribution deduction and the exemption from taxation of the endowment income of charitable institutions have been defended in two major ways: that charitable organizations fulfill public needs that would otherwise be unmet; that this activity should be encouraged in ways that avoid detailed government control over the charitable or philanthropic activity.

Income tax deductibility and income tax exemption appear to satisfy the second of these conditions, which we refer to as the pluralist argument. Government control is limited to defining what are "good" activities, like education, religion, or research, and laying down some very broad conditions for eligibility for favorable treatment. We think, however, that these are not the only ways in which government could encourage charitable activities without exercising detailed control.

The first argument is harder to deal with. To economists unqualified use of the word "needs" is close to meaningless. Choice is an important characteristic of human life. One can live in different ways. In a very basic sense economics is about ways of choosing between alternatives. The notions that we "need" more oil or more capital or more education are basically faulty. In a world of scarcity the fact is that if we get more oil, or more capital, or more education, we will have less of other goods and services. The economic problem is to achieve an allocation of resources among alternative uses that in some sense is optimal in view of societal preferences.

One example will serve to make clear the kind of problem that is involved in the allocation of resources. There is considerable reason to expect that a private economy would invest too little in basic research. Thus, government support of activities like oceanographic studies and the National Institute of Health is useful. There is considerable participation in the particular area of medical research by charitable organizations such as the Heart Fund, the March of Dimes, and so forth.

Determining the total level of expenditures and determining the allocation of these expenditures between alternative projects are the economic problems of the medical research area. An allocative mechanism used by the charity sector is the technique of competing public drives. It seems to us that one could hardly design a worse way to decide how research funds should be divided between muscular dystrophy, cancer, or heart problems, say, than to base the decision on the "pay-off" from competing publicity campaigns.[1] The campaigns compete on the basis of gimmickry unrelated to any rational criteria of return from research programs in alternative medical areas.

The problem of allocation between competing medical research projects is merely an example of the broad problem of allocation of resources. In the

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education area there are many different kinds of institutions. By choosing which kind of institution should receive gifts, contributors effectively allocate resources. For example, one could choose between religious and non-religious institutions, between liberal arts and hard science programs, or between medical classroom education and medical hospital education. Furthermore, any educational institution can develop in alternative ways. The prospect that contributions will be more abundant if one or another mode of operation is pursued is likely to have some effect on the kind of education that is provided.

The statement made by charitable organizations that they fulfill public "needs" is tainted with considerable *hubris*. We can say with complete objectivity that charities change the allocation of resources. It is quite acceptable to say also that some of these resource allocations are in the public interest. However, one would expect on the basis of probability alone that some charitable activities would work out against the public interest in the sense of spending money in ways that produce less aggregate utility than would have occured if contributors had spent the money on themselves in the first place.

The questions to which this essay is addressed are

- Could society establish mechanisms other than contribution deductibility not involving specific government control of the appropriation-expenditure type to direct resources into nonprofit activities?
- Is there reason to believe that some of these alternative mechanisms would bring about a better allocation of resources than the contribution subsidy?
- What implications does this analysis have for specific amendments to the tax provisions relating to charitable contributions?

I

A CLASSIFICATION OF ALTERNATIVE APPROACHES TO ENCOURAGING NONPROFIT ACTIVITIES

This section is limited to a discussion of possible alternative ways to encourage nonprofit activities without any specific attempt to evaluate the alternatives against tax benefits for contributions. We are trying to find alternatives that potentially can be designed without specific government controls. (Evaluation comes later.)

The most general features of the alternatives that we suggest arise from the fact that, in general, philanthropic activities are intended to help fairly specific classes of people whom we will designate as clients. We envision alternative government supports in the form of systems of subsidizing payments by clients.

A priori the people affected by charitable activities are apt to have good ideas about what kind of charitable activities would most efficiently serve to improve their condition of life. The suggestion of looking at possible client payment subsidies is behind our subtle language change in the title of this section from "philanthropic activities" to "nonprofit activities." The word "philanthropic" emphasizes the attitude of the giver and the giver's opinion of what would be good for other people. The word "nonprofit" underscores the simple fact that clients, left to their own devices, would not pay the costs of the services being provided to them. The allocation question is, to what extent these services should be provided even though they do not meet the market test.[2] We think there are ways to exploit how much clients are willing to pay as a clue to the appropriate subsidies and that these would be better than paying a philanthropist to make the decisions.

The great variety of charitable causes makes it difficult to identify a client payment in each case. Our search for alternatives will deal separately with the major kinds of charitable purposes.

Education

The client payment is conspicuous in this area—tuition and fees. College education is a major benefit to the students who are educated: in addition to its psychic benefits, it pays off in higher lifetime incomes.

On economic grounds the argument is strong in favor of a system of tuition-supported education with generous loans available and with the repayment related to post-college income.[3] As a political matter, the entrenched lobby of the state-supported schools is a barrier to shifting to tuition financing on a massive basis.

There should be, however, no political barrier to a federal program that would match tuition payments on a 50 percent basis up to say the first $400. A tuition tax credit plan sponsored by Senator Ribicoff was several times adopted by the Senate in the mid-1960s, and only failed final passage due to the opposition of the administration. The Ribicoff plan would have provided average tuition supplements of $200, with larger ones for very high tuition schools and with none for students who were self-supporting or who were from nontaxable families. The greater uniformity of a tuition matching system should make it more attractive than the Ribicoff plan.

Medical Service Organizations

Here, also, there are conspicuous client payments—hospital service fees. The federal government could match such payments, or match payments up to $50 per day, or meet the formal service fees with regard to poor patients, as is done now through Medicaid.

We think it highly likely that the federal government within the next several years will establish some sort of comprehensive medical insurance program setting up ample channels for payments to hospitals related to their service charges. Building some subsidy into these payments as an alternative to the present contributions to hospitals is merely a matter of covering a part of the payments that will not be financed either by the employers tax or by new taxes.

Religious Organizations

Religious organizations are rather unique in that they are membership organizations without formal dues or fees. Although the contribution is not charged explicitly as a membership fee, it does affirm the relationship of the family to the church. The church contribution is used either for provision of religious services and religious education to the church membership (usually open to new members and visitors) or for philanthropy directed to people outside the church. The portion directed to philanthropy outside the church is commonly not separately identified when the contribution is made, although there may be identifiable separate collections within the church for some non-church philanthropy. (Separate studies being conducted for the Commission on Private Philanthropy and Public Needs may throw more light on the uses of church contributions. Our study must, however, proceed on the assumption that some unknown component is for non-church purposes.)

A further complication of the religious area of philanthropy is the uncertain constitutional status of forms of government aid other than deductibility of contributions, exemption from taxes on endowment income, and the analogous exemption of church real estate from property tax. In recent cases, the courts have reaffirmed a very severe First Amendment constraint on government aid to religious education but have been willing to be quite generous with regard to accepting the status quo on the indirection of tax benefits for religion.

The upshot of this discussion is that the preferred approach to handling the religious area of philanthropy is to regard the church contribution as a client payment. This would be entirely acceptable on theoretical grounds if church contributions were used entirely within the church or were used only to a minimal extent in outside philanthropy. We don't know if this is the case and return to this matter later.

First, as to church contributions proper, we need not decide at this point whether the appropriate treatment should be continued deductibility, a tax credit, or a matching grant system. These matters are being explored in separate studies for the Commission.

A possible problem would arise from retaining the deductibility of religious contributions (or from providing separate matching grant or tax credit devices for religion) while changing the other kinds of nonprofit activity support to subsidies for client payments. It could develop that there would still be the opportunity to obtain a tax subsidy for contributor payments by channeling these through a religious organization.

This difficulty could be avoided under the matching grant arrangement because the amount to be matched could be reduced for the amount transferred to non-religious charities which were being subsidized by other than contribution deductions. (Religious organizations would be required to report the amount transferred to non-religious charities.) In a tax credit arrangement or deduction arrangement, contributions up to, say, $50 a year to any church could be deductible or subject to the credit in full. Amounts over this could be allowed only if the taxpayer submits a receipt from the organization indicating the percentage of its annual contribution income that went to non-religious charity.

Welfare Activities

Charitable activities in the welfare area cover a wide range of activities, including relief to the poor, relief in special personal circumstances such as those of unwed mothers, relief in the face of natural disasters, supplemental military payments, and foreign aid.

Some alternatives which are not authoritarian and which deal with much of the general area of relief to the poor are comprehensive systems of money relief payments, such as the negative income tax, the Family Assistance Program, or, to a lesser extent, the existing welfare programs. A feature of many programs to aid the poor, including government food stamp and public housing programs, is that they involve an element of providing the poor person with what the benefactor thinks that person needs. A negative income tax, even one operated by the central government, has a stronger element of freedom since it leaves to the family the decision about how to use resources. This is a freedom that consumers in general have, that is, how to spend their money.

Beyond the Salvation Army type of general relief for the poor, welfare charities are concerned with disaster relief. This is clearly an area in which there has been an increasing direct public role, and it may well be that in this area pluralism is not a viable concept. An important characteristic of any welfare system would seem to be equal access to relief by those in need (a kind of welfare rights). A pluralist system, by its nature, is liable to promote regional and other types of differences in the level of available relief services.

Another kind of private charity welfare activity is military support in the form of morale-related fringe benefits of the type provided by the Red Cross. While these services could be provided by the military itself, a possible pluralist form would be one or more nongovernment organizations of service persons. Such organizations could be supported by both membership contributions and government subsidies related to membership dues and other gate receipts. These organizations might take the form of fraternal unions or simply clubs and could compete for government support.

In the area of foreign-aid charities, presently represented by CARE or HOPE, a clear alternative is a government program that extends a subsidy related to the aid given. The government subsidizes the existing CARE program by making available low-cost food for foreign distribution. The present subsidy for the individual contribution could be transformed into a higher government operating subsidy.

Artistic Activities

Most artistic activities are supported by a combination of philanthropy and admissions or user fees. In this there is a close similarity to institutions of higher learning, even to the point that there are free art galleries, just as there are zero-tuition public schools.

On economic grounds, we argue that for higher education there ought to be tuition even where there is none now, since the principal beneficiary is the student rather than society. The same argument could be applied to artistic efforts. Performing arts such as ballet, if they are to have value, must involve appeal to an audience. If we can say that in all cases some audience appeal is a *sine que non* for a valuable art form, then it would follow that some level of admission price could always be charged and that a subsidy could be related to this price.

This suggestion of an admission subsidy does not, however, go to the real problem because some public performance activities charge admission and are self-supporting without subsidy (for example, popular music, exotic dancing, and professional sports).

The problem, from our standpoint, is that the philanthropic institution presently identifies some non-self-supporting activities which are considered to be of such artistic merit that they ought to be maintained even though they cannot charge a level of admission that will cover costs. Thus philanthropy is extended to ballets and symphony orchestras, but an organization such as a nightclub which would like to make a profit but can't due to poor management, poor location, or poor talent is excluded.

We accept here that there is social value in maintaining activity in a selected variety of non-self-sustaining arts.[4] The question is how to construct a mechanism for both choosing among the particular institutions requiring support and deciding on the degree of support appropriate in each instance.

We conclude that in the arts area, the amount of admission receipts is a poor guide to appropriate subsidies. Judgments, exemplified by the following, must be made: Local theater can be maintained at a quite satisfactory level with predominant reliance on admissions and only a small subsidy; ballet should be given a much higher subsidy relative to admissions. Such judgments involve operational costs and esthetic importance.

A general sort of mechanism for making these decisions which is an alternative to the government appropriation process is the semi-autonomous government agency such as an arts council. The advantage of such a council is that some specific spending decisions are transferred to an agency other than the legislature.

Basic Research Activities

Private philanthropy supports research fairly directly as well as through support of institutions such as hospitals and universities. It is well known that successful research will often generate benefits that cannot be captured exclusively by the person paying for the research. For this reason some research that has total benefits exceeding cost will not be undertaken privately for profit because prospective benefits for the investor will not exceed his cost. The patent system tries to deal with this by increasing the opportunity of the inventor, and his related investors, to capture the benefits.

It is generally recognized that the more "basic" the research—that is, removed from specific applications—the greater is the prospect of noncapturable benefits and the less likely it is that the research will be carried out by a profit-seeking business. Research of this character is typically supported by government and/or by private philanthropy. The critical question here is analogous to that in the artistic case, "Which activity will be financed?" The mere fact that research is involved is enough to establish that no precise cost calculus is possible, although there is considerable basis for experienced judgments of the type that "work in such and such a field is close to a breakthrough that will produce socially important results."

Financing researchers through private charities is one plausible way to put more money into research. However, at the present time, a far greater portion comes from government. The bulk of government research support comes through the appropriation process, but only in an indirect way. Government agencies retain flexibility in specific research specifications. Furthermore, government agencies like the National Science Foundation have great leeway to finance "basic" research. In principle, the quasi-autonomous structure, like an arts council, could be a viable alternative for directing research funds.

The broad structure of a research council can be further narrowed by relating it more particularly to a user group. The government could, for example, establish a quasi-independent research financing organization in the medical area analogous to NSF. A feature of this organization could be to establish formal voting procedures involving licensed medical practitioners as a basis for choosing between alternative research programs.

II

EVALUATION OF NONCONTRIBUTION ALTERNATIVES

General

This section presents some of the evidence that we have been able to assemble as to the nature and strength of the incentives affecting the behavior of nonprofit, or charitable, activities under a system of contribution subsidies or under some alternate subsidy system. The evidence is necessarily fragmentary. For one thing, we have had more experience with contribution subsidies than with alternatives. It is useful, however, to put down what we know, which is a combination of (1) theoretical insights as to how organizations should behave if their success depends on attracting contributors in contrast to attracting clients and (2) some record of results under the contribution subsidy system.

Before getting into these matters in detail, we want to offer two general comments which are relevant to how the reader should approach the evidence we offer.

In the first place, the mere fact that the alternatives that we describe are based on consumer choice makes them potentially attractive. While we are willing to modify our acceptance of consumer sovereignty in particular situations, the fact is that this is what our capitalist economic system is built upon. In one view of history, the varieties of paternalism are more shackles on the exercise of free choice that are to be overcome. These include the notions of the "white man's burden," "noblesse oblige" and the like. As civilization advances, our conception is that social relations should increasingly become a structure of interaction between equals. This has occurred as we have gradually dispensed with institutions like monarchy and slavery.

We should face the fact that the charitable institution is ultimately paternal. It is the contribution function that uniquely epitomizes this paternalism. Because a charitable institution is dependent on contributions, the contributor has the power to select which charity is worthy of his generosity, and the beneficiary is ultimately dependent on the motives of the contributor. This system can be extremely offensive when the public system of subsidizing contributions provides the greatest subsidy to the richest contributor. All of this is to assert that the reader should look seriously at the idea of alternatives to contribution subsidies.

The other general comment that we offer is one of moderation. Even if one were impressed with the possibilities of the alternatives to contribution subsidies, it would by no means follow that private contributions should be eliminated. There is available a wide range of policy options. A reader could conclude, for example, that

- The contributions deduction provisions should not be repealed, but they should not be made more generous. Future increases in government support for nonprofit activities should be in the form of alternatives to contribution subsidies.
- The contributions deduction provisions in the tax law should be tightened up by eliminating some abuses (such as the non-imputation of gain on contributions of appreciated property) or by providing a deduction floor, or by removing the wealth bias by converting from deductions to credits, and so forth. Any prospective decline in receipts of charities should be dealt with by alternatives to contribution subsidies.
- Contribution subsidy is particularly inadequate in certain areas like medical research. This leads to recommending excluding some kinds of organizations from those eligible for the contribution subsidy (section 501(c)(3)) and designing different subsidies for those organizations.

This range of policy options suggests that a reader should be able to evaluate these incentive issues with an open mind. The options are open to allow either a large, a small or no role to alternatives to the contribution subsidy.

Education

The role of contributions in support of education in the United States is most visible in higher education. An appreciable amount of deduction must go to contributions for elementary and secondary religious education, but we prefer to regard this as a dimension of religious support rather than education support. The privately endowed, non-religious, secondary schools are a very small part of the educational system.

The thrust of this section will be aimed at investigating the role of contributions in the behavior of the higher educational establishment.

In the wake of the student riots of the late 1960s there was considerable debate about who should "run" the universities. One dimension of those protests was a contention that at present ultimate power over universities rests in the hands of the wealthy. "The owning class runs universities, much as they run the rest of society."[5]

Other observers of higher education in the United States find much that is explained by regarding the system as serving the two functions of expanding the forces of production and reproducing in the next generation the social relationships of the capitalist-producing system.[6] The general dimensions of this orientation are claimed to include a general disposition to develop favorable attitudes toward existing business structures, a selective elitist education for the next generation of executives, and efforts to sidetrack a large number of students into dead-end specialities required by present technology. This orientation is not asserted to be the unique result of contribution support of education, but rather it is claimed to be a product of the whole social system, including such circumstances that business firms will ultimately do most of the hiring of college graduates and have the power to control one of the determinants of successful education, the earning of good income.

We do not intend to debate the fundamental importance of this radical perspective of higher education. Our immediate concern is limited solely to the question of whether one of the social methods of subsidizing education should be to subsidize contributions in a way that the contributions of wealthy people attract more subsidy than do the contributions of middle- and low-income people. We do take note, however, that there are a vareity of institutional pressures that work on the direction of making higher education particularly responsive to the needs and attitudes of the wealthier classes. Against this background the particular incentives created by universities seeking contributions may be rather mild in themselves, but they may be quite objectionable as a marginal increment in the influence of wealth holders on educational content.

Evidence of Overt Contributor Influences

Overt contributor influences take the form of direct restrictions on uses of contributions. In the past, such influences often had large beneficial effects on the shaping of education especially with respect to innovation. Thus, money given by John D. Rockefeller to the General Education Board gave rise to standards for American medical schools and thus drastically increased the quality of these schools.[7] Similarly, starting with Stephen Van Rensselaer, trade and applied science schools were rapidly added to the American scene by the philanthropy of various people.[8] Compare, however, the case of Joseph Wharton who required that viewpoints favoring protectionism in foreign trade be taught in his new school of finance. In his own words: "No apologetic or merely defensive style of instruction must be tolerated upon this point, but the right and duty of rational self-protection must be firmly asserted and demonstrated."[9] Because of the rising costs of basic education and the decreasing role of philanthropy and the increasing role of government in funding it, no longer can one very wealthy donor have the shaping effect of a Rockefeller, Rensselaer, or Wharton on the educational system. However, gifts can still be given for restricted uses and these gifts, although they be small in size compared with the whole of income, may be important to an institution in maintaining its relative position among its rivals. An institution may still be shaped in part by its benefactors. In the late 1960s it was related to one of the authors that a major university was told that it would experience a considerable decline in the level of contributions if the dean of its law school persisted in a public position critical of tax benefits for oil and gas.

At least in the area of corporate gifts, evidence points in the direction of a tendency toward unrestricted gifts and thus toward a lessening of any overt contributor influences. According to the Council for the Advancement of Education (C.F.A.E.), a sample of 207 companies showed for the period 1956 to 1960 an increase in unrestricted gifts from 35.7 percent to 52 percent of total gifts. Furthermore, the remainder went, in decreasing order, to student aid, buildings and equipment, research, faculty salaries, department grants, and endowment.[10] Much of this restricted aid, then, was for the purpose of helping fund traditional university operating expenses rather than for purposes which might be of direct benefit to the corporate giver or which might bend the university toward corporate viewpoints.

It must be said, however, that the restrictions on some gifts are to the benefit of corporate givers and are often detrimental to universities. One author has stated that the main corporate objection to unrestricted gifts is that they fail to place the company name before the students.[11] Some corporations thus offer gifts-in-kind, in the form of equipment or materials which bear the company name, but which in the words of one university president "tend to determine the program within which the university must use them."[12] Aside from the benefit of having its name on such gifts, the corporation may benefit by hiring from the supply of graduates of programs established around the gift of its equipment. At any rate, the university has been led to expand in a direction that it might not otherwise choose strictly on the basis of what one department sees as its educational priorities.

Overt influences via restrictions may even extend to the establishment of professorships. In 1958 the Bankers Trust Company underwrote a professorship of banking and finance at the Graduate School of Business at Columbia University. The bank requires an annual report by the business school dean which is to include a section on the professor's "relationship with the financial community" as well as the usual information on his course responsibilities and research.[13] Under the contract setting up the professorship, the bank or the business school can terminate it with three years notice, hardly a condition to encourage independence. Indeed, the bank's reason for setting up the chair at Columbia was its "long-standing relationship" with that institution which is emphasized by the fact that "many on the bank's staff had studied there."[14]

Another type of overt influence occurs where services are offered by the educational institution in exchange for "unrestricted" gifts over a certain size. Thus, the gifts are conditional in the sense that the giver knows he will get a real return on his contribution. A striking example of this type of gift is the Affiliate Plan of the Stanford Graduate School of Business,[15] under which givers of over $1,000 get the following services: (1) They may use the school's Jackson Library of Business; (2) The school's placement service extends the fullest cooperation to affiliates in locating properly qualified graduates for employment; (3) Reports of research that contribute to more effective management and other publications of the school are sent regularly to each affiliate; (4) Special seminars, on subjects such as industrial relations, marketing, corporate finance, and government and business, are developed exclusively for key men of affiliate companies; (5) Affiliates are invited to participate in all management programs and business conferences sponsored by the school.[16] Again, there is probably social value in this type of program as education is linked to its application. For the company, the return on its donation is clearly of value as the company is given access to information and educational services even to the extreme of setting up special seminars on subjects of company concern. Furthermore, the company is being given aid in recruiting employees.

How one evaluates the use of business contributions for self-serving business goals is not altogether clear, since such outlays are expenses of advancing the profit prospects of the business. We think that there are good reasons for raising questions about the deductibility of these contributions, however.

First, the Congress already restricts the use of the deductible business expense to influence government policy through political grass-roots lobbying expenses (advertising and mass mailings)[17] and through corporate political contributions.[18]

Second, we are dealing with corporate contributions to an existing institution which ostensibly has as its goal the advancement of education among all members of our society. To the extent this social institution is diverted to advancing narrow business goals, the most basic reason for its existence is subverted.

We can say, then, that the majority of gifts to educational institutions, at least from corporations, bear no restrictions or are restricted to general costs of operation and do not overtly benefit the giver or advance his viewpoints in the university. Assuming that these gifts come without overt influence, we may say that control over the composition of the educational system has apparently remained with the educational administrators. Even with apparently unrestricted gifts, however, it may be an effective constraint on the behavior of educational institutions that they must act in a way that makes them attractive recipients for future "unrestricted" gifts. We turn next to this covert influence.

Evidence of Covert Influences

Covert influences may arise from the anticipation of contributions. One type of covert influence which the flow of business dollars might have on educational institutions is insuring that the trustees of the university discourage anti-business or anti-free enterprise attitudes and intellectual pursuits. There is evidence that the boom in post-World War II corporate giving arose from an attempt by business to endear itself more to students, to academics, and to university trustees. Indeed, Judge Alfred P. Stein, who presided over the New Jersey case (begun in 1951) upholding the right of corporations to make donations to education, declared such contributions "necessary to assure a 'friendly reservoir' of trained men and women from which industry must draw."[19] Stein went on to say: ". . . I cannot conceive of any greater benefit to corporations in this country than to build respect for and adherence to a system of free enterprise and democratic government, the serious impairment of either of which may well spell the destruction of all corporate enterprise."[20]

An important question in the consideration of this type of covert influence is what the actual attitude of the corporate giver is toward the universities to which he gives. One test of this attitude is business responses to the teaching of socialist doctrine in the schools they support. Unfortunately, much of the debate about corporate criteria for giving occurred in the early 1950s, immediately after such giving was sanctioned by the New Jersey court case. Thus, we can expect attitudes to be tainted by the fear of Communism that gripped Americans in that period. Attitudes do seem to fall into two distinct categories. One group, respecting "academic freedom," would not withdraw aid if universities criticized capitalism.[21] Another group had other opinions about university activities. Merle Curti and Roderick Nash, in *Philanthropy in the Shapinng of American Higher Education,* cite several of these opinions. For instance; Frank Abrams, a Standard Oil Company executive, offered the opinion that: "Our teachers must be strengthened in their belief in the American system of democratic capitalism by a more equitable participation in the rewards of that system."[22]

Abrams denied, however, any desire to make universities teach a certain dogma. Another executive quoted was more explicit: he "would find it hard to vote to give money to a college where they taught that the (his) company should be taken over by the government." Curti and Nash cite still another instance where the Committee to Visit the Department of Economics at Harvard which was chaired by a businessman "criticized the department's balance 'with respect to the viewpoint of its members'" saying that "there were 'one or more socialists' in the department and that other viewpoints were under-represented." The president of Harvard disagreed with the committee on this point and refused to hire or dismiss faculty on the basis of their political beliefs.

Thus, we can see that some corporate givers did have ideas about the direction that education should take and were forthright in stating them. Curti and Nash state that "As a rule, however, corporation executives denied any desire to control curriculum or faculty composition in any overt way."[23] They go on to cite only one isolated instance of officers of a company using their financial power "to force the dismissal of a faculty member whose opinion they opposed."[24]

Although overt incidents were few, there is evidence that the attitudes of the corporate givers did have an effect on the universities. Many universities, for instance, based their solicitations at least in part on "the appeal of private education as a bulwark of private enterprise."[25] Some, such as Harding College in Arkansas, even made this point the focus of their solicitations.[26] One would think it would be difficult for such institutions soliciting as "bulwarks of free enterprise" not to be wary of one of their number who espoused views critical of capitalism. It is here that covert influences operate, and although they may be unmeasurable it is hard to believe that they are absent. The motives of giving to universities out of a "pre-occupation with the survival of the free enterprise system" seems to have declined somewhat since the McCarthy era: A 1960 C.F.A.E. survey found in a survey of 200 business givers that only 99 listed as one of the motives for giving "Insuring free enterprise system," placing it third behind "creation of educated manpower" and "meeting community responsibilities."[27] However, it is significant that still roughly one half of the companies surveyed listed that motive.

So far we have spoken only of corporate givers. Yet evidence points toward the predominance of businessmen among the big individual donors to universities. Indeed, in a survey of donations to 19 institutions of higher learning, businessmen (who represent 10 percent of the total American working force) made up 48.9 percent of the total group of donors comprising the top 24 donors to each institution, 57.4 percent of the group comprising the top 10, and 65.2 percent of the group comprising the top 5. In bleak contrast, government-employed donors made up 0.9 percent, 0.5 percent, and 0 percent and educators 4.4 percent, 1.6 percent, and 2.1 percent of these categories.[28] Thus, among individual large donors (who, one would think, might be influential), businessmen predominate. One would expect that these businessmen would have a similar variety of attitudes as those who make donations for their corporations.

Covert influences on universities and on their personnel may therefore arise from the existence of corporate financing and from the large percentage of businessmen among big individual donors. If one holds the opinion that universities should in some ways pass on to a new generation the principles and institutions of the old, then those covert influences may not seem particularly odious. However, there is evidence that in some instances such influences prevent the universities and their personnel from serving fully the larger society. To quote Senator Lee Metcalf of Montana:

> Mr. President, the stultifying effect of close financial ties with oil companies and other energy corporations is a subject of which the Senate has considerable knowledge. There is, however, no great body of literature published regarding the relationship between these corporations and the universities.
>
> It is sufficient here, I believe, to remember the difficulty which California and federal officials had in obtaining university experts in the wake of the oil leak off Santa Barbara early last year. Some university experts did not want to endanger their consulting arrangements and industry grants.[29]

Covert influences may be wholly unintended by the contributor.

A more substantive commentary on the state of influences is the paucity of Marxist oriented professors in the United States universities. Given the importance of Marxist thought around the world, it might be expected that there would be an ample supply of competent Marxist scholars. It could also be expected that an educational institution devoted to objectivity would try to present alternative viewpoints from the standpoint of supporters of the different viewpoints.

Locality Effects

Corporations have also shown a tendency to contribute more to educational institutions in their locality.[30] Reasons for this range from public relations through the fact that often a large part of the industry's employees may have come from these local institutions. Such donations do no overt harm, but there is a danger of misallocation.It may be that the pay-off in education for the country as a whole might be higher if these dollars were directed to another area. For instance. it may be the case that locality effects give areas of heavy industrial concentration, areas which are probably already wealthy and able to provide for higher education, a disproportionate share of the corporate dollar. Conversely, poorer areas, where the benefits per dollar for local colleges may be higher, might get a disproportionately small share of the contributions. We must remember that corporate donations are partly a federal tax expenditure so that possible misallocation of funds between areas is a valid concern.

Alternatives to Contribution Subsidies

A major alternative to contribution financing of higher education has been support from direct appropriation by state legislatures. The initial assumption of this study, which accepted the pluralist viewpoint, excludes our recommending this alternative.[31] This restriction does not leave us uncomfortable because there is ample evidence of actions by state legislatures which reduce academic freedom.

A pluralist alternative to contribution subsidies is to subsidize tuitions. It is quite plausible that a tuition subsidy plan could be designed to minimize the income constraint arising from the fact that tuition is very large relative to family income for a substantial part of the population. The technique could be a system of tuition loans with repayment related to subsequent income. There is considerable economic literature on these plans.[32]

This approach to massive tuition financing of education represents a dramatic change in the relative position of publicly supported institutions and is probably not a politically feasible alternative. Short of this, however, one could design a tuition subsidy plan which started from the limitation that the net contribution to education would be as much through tuition subsidies as it is now through contribution subsidies. To maximize the tuition impact this would have to be structured to be some flat portion of tuition. Based on the latest summary data as to sources of income of institutions of higher education, this would be about 25 percent assuming that the present level of student tuitions is about $6 billion and the revenue loss from all higher education contributions is $2 billion.

This approach would involve relatively higher federal subsidy for private institutions that already rely heavily on tuition. Recognizing the political realities, it would be possible to structure a tuition subsidy that was some percentage of the tuition plus some flat amount per student. To the extent of the flat amount per student a presently tuition-free, publicly supported school could impose a nominal tuition that would be covered by the subsidy.

Even with the flat subsidy per student, the schools would be in the position that their financing would depend on the number of students, which gives rise to a different set of motivations from being dependent on the generosity of wealthy contributors. With a subsidy related to the size of tuition, the student influence in school operation becomes stronger since the school achieves more subsidy to the extent that it provides a product that the student thinks is worth the tuition cost.

In a basic sense, education is concerned with passing on to the new generation the accumulated wisdom of the older generation. We would expect that the older generation would exercise considerable control in this process even with increased importance of tuition (market) financing. Ultimately the older generation through its control of the hiring process in society will impose a qualitative control, through accreditation and rating of various degrees, that will create a pressure for students to obtain an education and acceptable grades from an institution that will be recognized for good jobs.

Within this general constraint, however, it seems to us that the marginal adjustments in university orientation that would be associated with making tuition a more important source of financing and contributions a less important one would be healthy. A student of 18 is regarded as old enough to vote and he or she is at a stage of life characterized by more openness to alternatives than is characteristic of older ages.

Medical Services Charities

In the medical services area, the clients are both afflicted people and well people who are potential victims of affliction. Presently most health charities provide funds for medical facilitis and services for the sick, as well as funds for research which benefits the well. We will deal first with the evidence on fund raising and expenditures by these charities for both services and research. We will treat these two kinds of activities separately when we discuss alternatives.

Aspects of the Present System of Tax Deductible Contribution Funded Health Charities

Health charities compete for contributor dollars, primarily by public relations campaigns. These public relations campaigns sometimes have used heart-rendering portrayals of victims (often children) to gain the charity dollar. For instance, the National Foundation, one of the five biggest health charities, appealed for aid on behalf of polio-stricken children. Yet many of polio's victims are adults so that the advertising implication that polio was strictly a "children's disease" was merely a clever public relations ploy.[33] National Foundation's dollars led to the Salk vaccine and to the disappearance of the threat of polio. We must ask, nevertheless, whether the method of competing public relations campaigns is a sensible way to allocate resources.

Marian Sanders wrote that medical crusades "are built on pity and terror, not statistics."[34] Scott Cutlip has compared multiple sclerosis with polio, stating that the diseases were "roughly comparable in the way they strike, in their role as a crippler, and in their effects."[35] He cited figures showing that before the polio vaccination, each of the diseases resulted in about 1,500 deaths yearly. Yet, the National Foundation, devoted exclusively to fighting polio, raised roughly $40 million annually compared with the Multiple Sclerosis Society's $1 million. Furthermore, these figures remained the same in the decade following the advent of the polio vaccination. The National Foundation, competently led and well staffed with volunteers, used expenditures from its large income in attacking arthritis and birth defects after conquering polio.

Meanwhile, a rather poorly managed Multiple Sclerosis Society struggled along with roughly one-fortieth the funds of the National Foundation trying to fight a disease which along with its variants had affected one-half million Americans living in 1961. This doesn't look like a rational allocation of resources.

Citing the disparity between the recipts of cancer and heart charities, Harvy Katz asserted in *Give!* that success in charity fund raising campaigns have reflected the technical skill of the promoters rather than the worthy nature of the cause. Heart disease affects fourteen times as many Americans and kills four times as many as cancer, and yet the heart charities had $56 million in receipts compared to $84 million for the more effective cancer charities in 1972.[36] Katz also cited the distribution of funds among all health charities as evidence of domnation by a few effective ones: five charities got 70 percent of the receipts, 4 more got 16 percent, and the remainder got 14 percent.[37]

Such an allocation might be justified if the top charities in receipts were also those that dealt with the most pressing health problems. We have already mentioned the Rosenbaum article detailing the fund-raising difficulties of the nation's primary kidney charity. Kidney disease is the nation's fourth biggest killer and yet the charity was 19th in contribution receipts within the class of health charities.[38] Such a ranking cannot be dismissed as one of a charity whose cause is not in need of funding: throughout the world there is a shortage of costly kidney machines which maintain the lives of the stricken. We see then that there are disparities between relative individual health charity receipts and worthiness of cause.

Aside from misallocation between diseases, there are cases of misallocation in specific research and service areas. The National Foundation spent $14 million in accumulating gamma globulin when it seemed to offer limited and temporary protection against polio.[39] Such an expenditure seems excessive when it could have been spent on further research into other prevention methods rather than on the material resources necessary for a massive program of fairly ineffectual protection. (Recall that this expenditure is equal to about 14 years of contribution receipts for the Multiple Sclerosis Society which was fighting a disease similar to polio.) The National Foundation also gave $15 million over 20 years to Warm Springs which had facilities to care for only 100 polio patients (through its connection in the public mind with Franklin D. Roosevelt it was probably quite able to raise funds on its own.)[40]

Another example of apparent misallocation was Jeane Dixon's plan to build a Jeane Dixon Medical Center in Washington, D.C., through Children to Children, a charity which she ran. The proposal to build came at a time when money would have been better spent renovating older hospitals. Prevailing opinion at the time was that Dixon's hospital would overall cause more harm than good.[41] Katz in *Give!* cited evidence that Dixon was more motivated by ego than goodwill in much of her charity work.[42] Although the hospital never came to be built, if it had it would have been funded in part by taxpayers backing up the tax deductibility of contributions.

Another example of a possible misallocation arose in testimony before the Mondale Subcommittee on Children and Youth.[43] Chief officers of the Asthmatic Children's Foundation described their expenditures on an Ossining, N.Y., facility for asthmatic children. The facility cost $1 million to construct and has had operating expenses of about $350,000 annually. The facility, however, has capacity for only 22 patients. Thus, over $15,000 is spent annually per patient. One wonders if comparable services might not be rendered for a lower price under client payment subsidies.

In the case of the Asthmatic Children's Foundation, however, there was evidence of mismanagement in an area besides services: the foundation had high fund-raising and non-program costs. Its fund-raising costs over the past 11 years ran between 64 percent and 80 percent of receipts, with a mean of 74.4 percent.[44] This compares with the 19 members of the National Health Council, which is supposed to be composed of health charities meeting certain standards, all of whom have fund-raising costs under 34 percent of receipts with most under 25 percent.[45] Non-program costs of the Asthmatic Children's Foundation ran between 74 percent and 90 percent of receipts with a mean of 84.6 percent.[46] Some part of the charity dollars spent on fund-raising and administrative costs are "donated" by taxpayers as a tax expenditure. The cost of administering client payment subsidies as a percentage of total allocation for the subsidies and administration may well compete favorably with the non-program cost percentages of even the best health charities. (An efficient charity might have fund-raising costs of 8 percent of receipts with 4 percent administration costs.)

It must also be noted that regulatory mechanisms preventing charity from overspending on fund-raising costs vary from none to fixed percentage of receipts limits in the states. On the federal level, there is no regulation. Senator Mondale inquired of an Internal Revenue Service official whether a charity which spent 99 percent on fund raising would still be tax exempt. Not only was the answer in the affirmative, but the IRS does not inform other agencies (such as the Better Business Bureau) when fund-raising costs are excessive.[47] Furthermore, the Better Business Bureau itself has only $30,000 in annual resources to investigate citizen requests for information on charities.[48]

There is a further possible waste of resources connected with health charities. This waste involves charity panels of medical experts who make the best case possible for the severity of the diseases for which their charity solicits. A Dr. Harting testified before the Mondale subcommittee concerning the literature of the Epilepsy Foundation of America. The literature claimed that there were four million epileptics in the United States and that "eplipsey affects more Americans than cancer, tuberculosis, cerebral palsy, muscular dystrophy, and multiple sclerosis combined."[49] Harting believed that there were only one million epileptic victims and stated that the literature's comparison with cancer was misleading since cancer patients die after a short period of time while an epileptic can spend a lifetime with his malady. Harting went on to list further inaccuracies in the foundation's literature, including a letter which implied that there were four million children with epilepsy.[50]

Arthur J. Grimes, Director of Membership of the National Health Council (NHC), of which the Epilepsy Foundation is a member, stated that they did not investigate the founation's literature claims since it had an excellent "professional advisory board" which Grimes assumed oversaw the literature. Grimes felt that NHC's investigating the foundation would essentially mean duplication of the professional advisory board's work.[51] He also felt that the foundation could get some doctors to testify to the accuracy of the four-million figure.[52] Thus, we see that the advisory board has probably chosen the highest epilepsy figure within the range of believable figures. Such a board could much more usefully spend its time allocating funds between diseases. Then, the board's job would not be to color the picture to favor the urgency of a particular disease for public relations reasons but would be the vital job of deciding where the medical service/research dollar might be most effectively applied.

There is certainly evidence that the competing public relations machines in the health charity industry contribute little to improving the rational allocation of resources. On the other hand, it would appear that charity provides a very small portion of health care funds and one might be tempted to dismiss the whole area as an irrelevancy. Katz has estimated that health charity receipts were only $360 million in 1972.[53] This must be in the neighborhood of 1 percent of medical-related outlays.

We think, however, that here as in the education area there is a dimension of covert influence arising from the fact that hospital management may be largely oriented to satisfy other fund sources than the patient. The financing of medical services is one of the difficult areas of contemporary social policy. The presence of charity receipts is only one of the circumstances that weakens the usual profit-maximizing motivations that arise where a seller gains only by satisfying customers. Grants from govenrments and interlocking directorates with Blue Cross are other circumstances that work in the same direction.

There has been a number of economics articles exploring both the theory and the statistics of the question, "How does a profit-seeking hospital behave differently from a nonprofit one?"[54]

This literature has a common theme in suggesting that nonprofit hospitals exhibit a bias toward excessive quality of service at a lower level of quantity of service than is true of profit hospitals. This is the theoretical expectation when the hospital's success does not depend as much on satisfying the customer as it does on satisfying other fund sources.[55] It also seems to be consistent with a number of measurements of hospital behavior.[56]

Our point here is not that charity is the sole source of non-client money in present hospital financing, but rather that charity represents another instance of a rather inefficient kind of injection of money into the hospital institution, and that we would be better off to look for ways in which money was at the disposal of customers (patients) and the incentives facing the hospitals if they were to compete for customer allegiance.

Client Payment Subsidy Alternatives

We now narrow the discussion to medical services, that is, we exclude research and payments for plant and equipment which will be considered in the next section. Currently, the charity system is set up with the paternal attitude toward consumer sovereignty. The "panels of experts" which allocate funds are composed of various executives in charities that have been successful in the public relations struggle for the charity dollar.

Alternative systems of paying for medical service are a major current political issue. From an economic standpoint, we see the difficulty here that medical service, unlike food, is characterized by the fact that one family would, if the income were available, spend a great deal on medical services while another healthy family would spend little on them. We can deal with the food problem by recommending income supplements, recognizing that we can tolerate the decision of a family to spend relatively little or much on food.

In the medical service area, the prevailing view is that if a particular procedure would absorb a very large portion of the income of a family, that family should nevertheless have the option to buy this service, but not the option to spend an equivalent amount of money in another way. This is merely a definition of the philosophic concept of a right to medical care, or a right to life. The whole notion is not easy to reconcile with consumer choice.

A number of the proposed systems of universal medical insurance attempt to compromise these disparate elements of right to medical service and consumer choice by less than 100 percent cost insurance, that is, by deductibles and partial insurance. In principle, some element of consumer choice could also be maintained by a system of alternative independent insurance carriers where the incentives for each carrier would be to provide a package of services which at the margin provided benefits exactly equal to the cost, with the incentive arising from the opportunity to switch insurance carriers.

Without entering into debates about specific terms of alternative universal health insurance systems, we offer the judgment that the success of these arrangements will be critically affected in that they leave room for individuals to make decisions as to whether services are justified by costs, and they leave room for medical suppliers to respond to such consumer judgment. Compared with this dimension of paying for medical service, subsidizing contributions may not be much worse than any other method of injecting dollars into hospitals in ways that by-pass consumer decisions.

Alternatives to Contributions Subsidies for Medical Research and Facilities

In the medical services area the patient was the client since he was the direct recipient of the services. In the medical research area, any well person is potentially a disease victim or is closely related to potential disease victims. The total public, however, is far from knowledgeable about their potential disabilities. We think it more useful to say that the direct clients of medical research services are doctors and not their patients. Doctors "consume" the part of medical research which they find relevant and transform it into an addition to the service package which they "sell" to their patients. Similarly, doctors buy medical equipment or joint medical facilities to set up a service package for prospective patients. Ordinary industrial research is paid for by operating firms in the business.

If we think about medical research and medical facilities in terms of ordinary business research or an ordinary common business facility, we encounter the same conceptual problem that complicates the market for medical services—the philosophic notion of right to service. It is broadly acceptable, as evidenced by the patent system, that if a group of firms jointly develop a new technique for producing shoes, they can maintain, for awhile, an exclusive access to it, which makes it plausible to arrange private financing. The notion of exclusive access to a new medical discovery is less acceptable. This lack of exclusivity is a basic characteristic of what economists call public goods, because without some kind of exclusivity such goods will not be produced by profit-seeking firms, but only by some public body such as a charity or a government.

We think that the public provisions can, however, be better organized by construction of a client relationship. In the area of public health research, for example, instead of leaving decisions to the appropriations committees of the Congress, or to self-constituted charities such as the Epilepsy Foundation, it would be sensible to structure marginal choice decisions between one kind of research or another, or between facility expansion and research, and to leave these decisions to a vote of certified MDs rather the way the government left decisions about wheat price supports and crop controls to a vote of interested farmers.

The advantage of this sort ot arrangement is that people with some knowledge of the final use of medical services would be exercising judgments about activities, facilities, and research which are ultimately concerned with the medical problems that practicing physicians are dealing with.

Welfare Activities

Relief to the Poor

It does not seem fruitful to undertake any empirical evaluation of results between public and private poor relief. There is much unhappiness with the present state of public poor relief, and we think that we are on the path to substantial reform in the public system. Whether or not there is adoption of a negative income tax or a family assistance plan, it is clear that the trends within welfare are to extend coverage to families with an unemployed parent, to introduce a less than 100 percent marginal tax rate, and so forth. These are clearly negative income tax factors.

We think that the root of the dissatisfaction with the present state of public welfare is related to two basic features which are present even more severely in private relief.

One basic problem underlying the dissatisfaction with existing public welfare is summed up in the term "welfare dependence."[57] In any welfare system which concentrates on helping the poorest of the poor, a concomitant is that relief is withdrawn fairly precipitously when the client family becomes slightly better off than "very poor." This cutoff serves to discourage self-help and to constitute a poverty trap, a continued welfare dependence. (This is not a recent problem. We think it was implicit in the old debates about the English Poor Laws.)

The broad approach of a form of negative income tax can, in principle, deal with the welfare dependence problem by arranging poor relief in such a way that it is not terminated abruptly as the client family obtains some independent income. This is the "less than 100 percent marginal tax rate" of the negative income tax plans.[58]

The other very basic problem in welfare is summed up in the term "welfare rights." In the last two decades it has increasingly been recognized that our basic constitutional concern with equal treatment under law requires that if we are to have social programs that aid poor people, it is repugnant to have such programs that involve arbitrary distinctions as to which poor people will be helped and which ignored.[59] The direction that must be followed to deal with this is partly to extend the normal concepts of law, such as due process. Another element in the solution is the recognition of a very great increase in the welfare load.[60] A third element is the extension of uniform programs over wide geographical areas.

If we are right in our argument that the two fundamental problems in the present state of public welfare are the "welfare dependence" effect and the "welfare rights" problem, it is conspicuous that these are two areas where private efforts are most inadequate.

We think that the only viable solution to welfare dependence is the gradual phase-out of the poor relief as the client family income rises. This sort of commitment makes poor relief very expensive and reduces the viability of private efforts. Private efforts are most likely to be concentrated on the very poor and to be terminated when income improves. Further, it is out of the question for private charity organizations to acquire any solid information on the precise income of a client family to serve as a basis for a judgment of how much relief to give. Private charities will not get access to income tax returns, or other government payment records.[61]

With regard to the other basic problem of welfare rights, we think that the potential of private charity is quite hopeless. Again a big element in any solution, as it was in the 1960s, is an enormous increase in cost. In general, private charities, to achieve success in fund raising, tend to emphasize a special client group (such as, aged, Indians, locals). It is also cumbersome and impractical to enlist the legal procedures for equal treatment to a private organization that raised its funds on the basis of an appeal to help Indians, or Jewish people, or the poor of Providence, Rhode Island.

We can concede that private charity in the form of poor relief serves some social function. It is, however, a blind alley as to achieving any kind of decent solution to the poverty problem. If people want to do it, fine. It does not seem incumbent on society to subsidize these efforts. Society's money would be better used in comprehensive programs.

Relief for Special Circumstances

It is plausible that some sort of poverty relief is appropriate in special circumstances where the relief demands are more than would be appropriate in normal poverty situations. Plausibly, the political institutions would be slow to recognize the special needs of the drug addict, the alcoholic, the unwed mother, and so forth.

A detailed historical examination of the record is beyond our resources. On a selective basis, the record of private charities is probably pretty good with regard to unwed mothers. Changing mores have probably reduced the trauma of the illegitimate birth to close to a normal matter covered as appropriate by welfare and Medicaid. There has been private philanthropic activity in child placement, but even here the bulk of support prior to adoption comes from government.

It is our impression that in the field of treatment of drug abuse, the private charity record is singularly undistinguished. Such experimentation that actually occurs seems to be mostly through government, especially local government.

Another kind of special relief is that provided by Legal Aid Societies and the American Civil Liberties Union. Here again the increasingly recognized problem is the importance of equal access to opportunity, which, we think, is the basis of extending access to legal services governmentally.

Disaster Relief

The popular image of one of the largest of the philanthropic organizations, the Red Cross, is very much associated with disaster relief. It is clear that the resources of even a Red Cross are adequate only for a relatively limited quick relief during the period of high publicity of a disaster. In fact, the substantial costs of recovery from disaster require governmental aids, as does much of the immediate relief. In any natural disaster, high among even the immediate needs are the restoration of public services, fire and police control, communication. Even in this stage, a separate role of a private organization such as the Red Cross must be severely circumscribed by the facilities put at its disposal by public authorities. It is hard to see that a private disaster relief organization does anything that could not be done as well by public agencies, including semi-public agencies, such as volunteer fire departments.

An obvious indication of inadequate resources is the inability to respond uniformly to disasters in various areas. According to one reporter, there have been "numerous" complaints that the Red Cross has been slow to respond to disasters that strike poor, Black areas.[62]

A commentary on the interrelationship between private and public disaster relief is that in the early post-World War II years the Red Cross was still campaigning against an increasing governmental role in disaster relief.[63] This position had to reflect a greater concern for the institutional bureaucracy of the Red Cross, rather than concern for disaster victims. The image of being *the* disaster relief organization would be important for maintaining contributions to the Red Cross.

Supplemental Military Programs

In the period 1968 through 1972, the Red Cross spent 38 percent of its resources for services to members of the armed forces, including personal services, counseling and recreation.[64] This function seems to be unique to the American Red Cross and is not done by other national Red Cross societies.[65] Understandably, the operation of a program of this sort is under considerable control of the military. It is not plausible that it operates in any way significantly different from the operations that could be provided by semi-autonomous servicemen's clubs in which servicemen could decide to spend dues and fees for services received. This latter arrangement seems more consistent with the concept of a volunteer army.

Foreign Aid

For the most part foreign aid activities of U.S. charities involve in their actual operation a type of matching of government and private dollars, such as is done by CARE. If it is desirable to provide subsidies for such activities it seems preferable to subsidize these outlays as they are paid out in foreign charities, which means that charitable uses of money are subsidized while the present system subsidizes the raising of money as well as charitable purposes.

Arts

Performing Arts

The efficiency question with respect to the alternative public and private approaches to subsidy of the performing arts has been carefully evaluated by Baumol and Bowen[66] in the light of European experience and in local U.S. experience. They find considerably more evidence of interference with artistic conduct under private than under public support. Baumol and Bowen see the potential problem of government support being that government support would be relatively heavy in the area of established institutions and would tend to discourage artistic innovation, but they find that this problem exists in private support as well. In a combination of government support through arts councils without deductibility for private giving and residual unsubsidized private giving there would still be two sorts of opportunities to encourage innovation.

The Plastic Arts

In our judgment, the role of deductibility with regard to arts like painting and sculpture is dominated by the special feature of the deduction on the market value of property contributions with no imputation of gain. (This feature is inherently illogical. When a person contributes money, he is, so to speak, giving away income on which tax has been paid. When a person contributes unrealized appreciation, he is permitted to subtract from reported incomes something that was never in income.)

The role of this feature in the art world can be described as follows.

There are two classes of "buyers" for art which we can call "privates" and "museums." Privates pay for art with money, and they hold their purchased art work for enjoyment and/or speculation. Museums "pay" for art sometimes with money, sometimes with "tickets." Ostensibly, the museum receives gifts. These gifts, however, involve a benefit to the seller measured by the value of the tax deduction. Museums have, for practical purposes, an unlimited supply of tickets, but the museum does not directly control the value of the tickets. That value is determined by a market appraisal.

We can say some interesting things about this market appraisal. Since many buyers will buy for speculation, the knowledge that museums are interested in the works of a particular artist or school will give rise to expectations that the price will rise for such works; and the expectation of price increase tends to justify itself as speculators create a demand for the artwork that they think will increase in price.

In normal markets, what contains speculative movements is a budget constraint facing buyers. What is unique to the art market under this peculiar feature of the tax law is that the ability of museums to "buy" art works for tickets is practically unlimited. Assume that paintings of a school sell at a base period for $100 a piece. If museums want these paintings, they may bid the current price on cash sales up to $200. A contributor would net up to $140 by contributing a painting the current market value of which was $200, and this is a free resource for the museum. By having occasional cash purchases to maintain the market, museums establish value for "tickets," that is, provide open-ended opportunity for speculators to recover a gain over their purchase price by donating the works.

The fact that the price has risen, by itself, generates some expectation of future rises, and some speculative demand. Since tax deductible contributions provide an almost unlimited potential, museums can by occasional purchases insure themselves of an almost unlimited supply of gifts.

Another feature of the present system of subsidizing art through the charitable contributions technique should be noted. There will be another art market in addition to the market provided by people wealthy enough to buy art for enjoyment or display in their homes and offices. A subsidy device that is keyed to the price of art is necessarily biased toward encouraging the particular kinds of art that are in demand for the homes and offices of wealthy people, since the key to the subsidy is rising prices of particular works plus a high tax bracket for the contributor. (Only with rising prices is it profitable to buy art in order to contribute it.) This provides no incentives toward other embodiments of art that might enter into the lives of ordinary people, such as awards for artistic design of common household articles.

One must conclude that a major effect of the present method of subsidizing the plastic arts by generous tax deductions for contributions to museums is the raising of the market price of art works, mostly for persons other than the creator. The beneficiaries are principally private holders who have purchased for speculation. The system is aggravated by the circumstances that museums have an almost unlimited supply of "tickets." In all of this, museums probably feel poor despite their ability to disperse benefits because the system drives up the price of art works and does not make much contribution to artistic work.

III

THE POLITICAL PROBLEM

Any program for subsidizing charitable activities must involve governmental controls. It is widely assumed that the system of providing tax advantages for contributions and for endowment income involves minimum government controls and that a program of subsidies that was subject to an annual budget/appropriation cycle would involve an objectionable degree of government control.

We broadly accept this statement of the problem, but we believe that the common assumptions must be severely qualified both on the side of the contribution subsidy and on the side of alternative subsidy arrangements.

With regard to the contribution subsidy, Chapter 2 was devoted to the argument that the mere decision to subsidize charitable activities by subsidizing contributions introduces a host of subtle controls arising through the private interests of the contributors and in the ways that charities must behave in order to make themselves attractive to people who control enough money to be important contributors. Furthermore, the contribution subsidy technique requires that government intervene to the extent of defining eligible charities, which can involve, for example, distinguishing between education and propaganda. Finally, the contribution subsidy technique, in the United States, has involved government in a regulatory role of insisting on certain standards of conduct by charities, such as refraining from political activity.

On the other side, one can state that in the abstract it is plausible to establish a government expenditure program outside of the effective appropriation area under which the government distributes benefits under exactly the same conditions as the tax deduction. We could, for example, agree to pay to universities cash amounts from government based on statements attached to tax returns of individual contributions.[67] While it appears that this payment system involves an open-ended appropriation account, the substance is no different from the open-ended agreement implicit in deductibility of contributions for government to sacrifice tax revenue in relation to private contributions. In a number of programs, Congress recognizes the need for effective open-ended appropriations. The Social Security program, for example, involves a commitment to pay specified amounts to people meeting specified conditions, no matter how many people turn out to be eligible.

We assume that some minimization of government control over charitable activities is an important objective of this Commission. It is not satisfactory, therefore, to leave this topic with the theoretical statement that the degree of control can be the same under both contribution subsidies and alternative subsidies. We need to ask whether there are reasons to think that the degree of government control would probably work out in practice to be different in the two modes.

This is not an easy question to deal with. We suggest that the evidence can best be handled by looking at sectors of charity. We think that religion is not very relevant, since we find there no alternative to a contribution subsidy.

In the area of education, the record of state-supported schools is, in our opinion, quite satisfactory. In particular situations academic freedom is interfered with by state legislators, but these kinds of interference do not seem to be much more frequent than with private schools. The federal government has programs that are akin to tuition subsidies in the form of GI education benefits, public information, and public education. Since charitable organizations are frequently dependent upon large contributors, it is understandable that the Congress would look to means of limiting the political uses of these institutions. Economics and politics may be distinguished by saying that in the realm of economics money speaks, and in the realm of politics, the rule is "one man-one vote." If we find ways of subsidizing charitable organizations with less reliance on the decisions of large contributors, the restriction on political activity could be less binding.

IV

THE RELATIVE COSTS OF ALTERNATIVE ARRANGEMENTS TO SUBSIDIZE NONPROFIT ACTIVITIES

To this point, we have been looking at a series of pair-wise comparisons of alternatives for government programs to increase receipts of certain nonprofit, or charitable, activities. Usually the comparison was between a system of subsidizing client payments or subsidizing contributions.

An element in the comparison could be the cost for obtaining a given amount of increased receipts on the part of the charity. We have not attempted to estimate these costs in detail. This chapter is devoted to some discussion of why we think such traditional cost measures are not very meaningful.

We start out by recognizing that a cost to government arises from a tax benefit which is provided not as a matter of income measurement, but as an incentive, that is, a tax expenditure.[68]

If we think only in terms of government budget cost, including the cost of tax expenditure, whether it would be cheaper to provide a given incentive to charitable activity by means of, say, a contribution subsidy or a tuition subsidy would depend on two circumstances: (1) the elasticity of the supply of tuition payments and relative to that of contribution payments;[69] and (2) the overhead expense that must be paid out of gross tuitions or contributions before finding the portion allocable to the educational activity.

We do not intend to undertake any careful examination of the statistical evidence of these circumstances. We simply offer the guess that in budget terms the contribution path is likely to offer the best budget payoff. This judgment is based primarily on recent work by Feldstein[70] and by Brannon[71] that the responsiveness of contributions to changes in tax rates is likely to be higher than had been estimated by Kahn[72] and Taussig.[73] We think that among the upper-income brackets, it is very likely that a dollar loss of tax revenue as a contribution deduction produces nearly $1 in added contributions. In the lower-middle brackets, this elasticity is near one half. The available evidence on the elasticity of demand for education in terms of tuition payments suggests that this is fairly inelastic, say, -0.5. The implication is that $100 million spent on contribution subsidies might increase contributions by $100 million, but $100 million spent on tuition subsidies would increase tuition receipts of colleges by, say, $50 million. This sort of relation is plausible. Tuition is only a part of the cost of going to college. The larger cost is the foregone earnings. Thus, a 50 percent reduction in tuition is likely to be about a 20 percent reduction in real college cost.

If it is true that the pay-off from contribution subsidies is better in this budget sense, does it follow that contribution subsidies are more efficient? The answer has to be "no," for two reasons.

One is the overhead expense related to contribution fund raising. This is likely to run in the neighborhood of 15 to 25 percent. The important comparison is between the net resources put at the disposal of the charitable organization for its charitable activities.

Furthermore, an induced charitable deduction through tax deductibility is a part of the burden of a tax system. Let us assume that with tax deductibility for contributions, taxpayers with incomes of, say, $100,000 pay tax on the average of $40,000 and make contributions of $10,000. Under an alternate system with no deductions and lower rates, we could specify that the tax would be $45,000 and the contribution $5,000. This is no more than assuming that the same budgetary needs are met both ways.

In a real sense, the social burden on these taxpayers is *increased* by $5,000 by deductibility of contributions. We can infer that the taxpayers preferred to pay tax of $40,000 and contributions of $10,000 to $45,000 of tax and $5,000 of contributions. The decision to have a system with higher rates and a contributions deduction simply precludes the taxpayer from the old option of a $40,000 tax and $5,000 contribution. Presumably, the burden of $40,000 tax and $10,000 contribution is lower than the burden of $45,000 tax and $5,000 contribution, but we do not really know how much lower. We cannot assume that the induced contribution of $5,000 is very much less of a burden than $5,000 of extra tax.

Similarly, it is not at all clear that one can attach much importance to a judgment that the elasticity of tuitions is less than the elasticity of contributions. If the supply of tuition dollars is very inelastic, then the increase of funds to universities through more contributions is likely to end up making tuitions less than they would have been and the money is "dissipated" in lower tuitions to exactly the same extent that a tuition subsidy would be.

At this state of our knowledge, we are not inclined to put much emphasis on any argument for one sort of subsidy or another which takes the form, "under subsidy A you get more bang for the buck." Verifying such an argument requires tracking down a lot of second- and third-degree consequences, and we suspect that in the end most bucks have about the same bang (or whimper) in terms of dollars going to charities. The important differences lie in the social effects connected with these dollars.

V

IN LIEU OF A CONCLUSION

There is no need to argue for a conclusion. Rather, we summarize this work in a series of attitudes which should be relevant to a variety of decision situations in which the Commission on Private Philanthropy and Public Needs will find itself:

1. The expression "public needs" is deceptive and should be dropped. What we are talking about is some public services which may or may not be more valuable at the margin than other public services that could be purchased with the same money.

2. In general, in the area that we designate as charity, it is our judgment that there is too little scope for the opinion of the people benefited as to whether the services proferred provide greater utility than some other services that could be offered.

3. This leads us to be highly doubtful about any tax amendment that would increase the amount of the contribution subsidy.

4. Client payment subsidies seem to us to be a very promising technique for replacing part of the present contributions deductions, and they still avoid bureaucratic decision making by transferring economic power to beneficiaries.

Footnotes

1. For a behind-the-scenes account of charity advertising, see Ron Rosenbaum, "Tales of the Heartbreak Biz," *Esquire*, July 1974, p. 67.

2. It is not responsive to the question to say that some services should be provided to poor people "because otherwise" they would be too poor to buy them. An obvious alternative is to give poor people money and let them choose how to spend it. We say more about this later.

3. Such a program was proposed in the report of the Zacharias Task Force in 1967. Their proposal would have established an Educational Opportunity Bank.

4. Cf. W. Baumol and W. Bowen, *Performing Arts — An Economic Dilemma* (Cambridge, Mass: MIT Press, 1966).

5. Statement of H. Bruce Franklin in *Who Should Run the Universities? A Rationale Debate*, American Enterprise Institute for Public Policy Research, Washington, D.C., 1969, p. 42.

32. Milton Friedman, *Capitalism and Freedom*; also *Priorities for Action*, Final Report of the Carnegie Commission on Higher Education, New York, 1973, p. 66; also the Zacharias Report, *Report of a Task Force on Higher Education to President Johnson*, 1967.

33. Harvey Katz, *Give!* (New York: Doubleday, 1974), p. 180.

34. Cited in Cutlip, op. cit.

35. Ibid.

36. Katz, op. cit., p. 62.

37. Ibid., p. 69.

38. Rosenbaum, op. cit., p. 68.

39. Katz, op. cit., p. 87.

40. Ibid., p. 81.

41. Ibid., p. 73.

42. Ibid., pp. 71-96.

43. Transcript of Proceedings, Subcommittee on Children and Youth of Committee on Labor and Public Welfare, February 5, 1974, pp. 37-38.

44. Ibid., p. 68.

45. Ibid., February 4, 1974, p. 47.

46. Ibid., February 5, 1974, p. 82.

47. Ibid., February 6, 1974, p. 21.

48. Ibid., p. 30.

49. Ibid., February 9, 1974, p. 34.

50. Ibid., pp. 40-45.

51. Ibid., April 9, 1974, p. 90.

52. Ibid., p. 94.

53. Katz, op. cit., p. 89.

54. Cf. for example, A.A. Alchian, "The Basis of Some Recent Advances in the Theory of Management of the Firm," *Journal of Industrial Economy* 14: 30-41, November 1965; K. Davis, "Economic Theories of Behavior in Non-Profit Hospitals," *Economic and Business Bulletin*, 24:1-13, Winter, 1972; M.L. Lee, "A Conspicuous Production Theory of Hospital Behavior," *Southern Economic Journal*, 38:48-58, July, 1971; J.P. Newhouse, "Toward a Theory of Non-Profit Institutions: An Economic Model of a Hospital," *American Economic Review*, 60:64-74, March 1970; J. Ogur, "The Non-Profit Firm: A Test of the Theory for the Hospital Industry," *Journal of Economics and Business*, 1974.

55. See Alchian, ibid.

56. See Davis, Lee, and Ogur, ibid.

57. This is given a key role in Daniel P. Moynihan's history of President Nixon's efforts to reform welfare. See Moynihan, *Guaranteed Minimum Income* (Vintage Press, 1972).

58. It is significant that at a critical stage in the debates over Nixon's Family Assistance Program, in the Senate Finance Committee, the administration lost heavily because it could be shown that as a result of the numerous compromises that had been made the marginal tax rate for an enormous number of cases was around 100%. Cf. Moynihan, pp. 463 ff.

59. See Robert O'Neil, *The Price of Dependency* (New York: E.P. Dutton, 1970).

60. A strong element in the "welfare crisis" of the late 1960s was the great increase in welfare caseloads following the activities of the various welfare rights movements in the early 1960s.

61. The much-publicized food-for-the-poor plan arranged by the Hearst family after the Patricia Hearst kidnapping is indicative. After hiring a reputed expert, the best that could be done was to drive a truck into a poor area and start handing out bags of groceries. Newspapers reported people driving up in expensive cars to get free food.

62. Katz, op. cit., p. 113.

63. Ibid., p. 114.

64. Ibid., p. 107.

65. Ibid., p. 109.

66. Baumol and Bowen, op. cit., esp. pp. 372-376.

67. See Paul McDaniel, "Study of Federal Matching Grants for Charitable Contributions," paper prepared for the Commission on Private Philanthropy and Public Needs.

68. Cf. Stanley Surrey, *Pathways to Tax Reform*, (Cambridge, Massachusetts: Harvard University Press, 1973).

69. It is arbitrary whether we speak of elasticity of the demand for education on the part of students and contributors respectively, or the elasticity of supply of payments.

70. See Martin S. Feldstein, "Estimating Separate Price Elasticities by Income Class," paper prepared for the Commission on Private Philanthropy and Public Needs.

71. G. Brannon, "Effect of Tax Deductibility on the Level of Charitable Contributions," Fund for Public Policy Research, 1974.

72. C. Harry Kahn, *Personal Deductions Under the Income Tax*, National Bureau of Economic Research, New York, 1960.

73. Michael Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," *National Tax Journal*, 20:1, March 1967.

A TAX BY ANY OTHER NAME: THE DONOR DIRECTED AUTOMATIC PERCENTAGE CONTRIBUTION BONUS, A BUDGET ALTERNATIVE FOR FINANCING GOVERNMENTAL SUPPORT OF CHARITY

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Introduction

Our paper analyzes the merits of four alternatives for providing governmental support to charity—the existing tax write-off, a tax credit, a sliding matching grant, and a percentage contribution bonus. After searching for an appropriate budget mechanism (a five-year fixed-sum authorization and appropriation), we apply a wide-ranging set of criteria—equity, legitimacy, efficiency, reciprocity, controllability, etc.—to each of the four alternatives. In brief, the existing tax write-off is grossly inequitable among donors, poorly controlled by government, and is part of a tax system increasingly viewed as illegitimate by citizens. The advantages of the write-off are that it produces predictable amounts of income at low administrative cost without overtly raising questions of constitutionality. Its disadvantages would be mitigated by a tax credit in proportion to the amounts contributed by taxpayers. But the credit does not reach people who do not file returns and may significantly decrease income to charitable agencies. The sliding matching grant (under which the government pays to charity in proportion as the individual gives of his income) provides a particular form of equity for taxpayers but is deficient in other respects. The contribution bonus—a percentage of each dollar contributed paid to charity by government—is wholly equitable, includes all givers, sustains reciprocity with recipients, is controllable by government, and is legitimate in treating expenditures as expenditures and not as tax dodges. It also raises the possibility of increasing the government's contribution. The defects of the bonus are higher administrative costs and potential doubt about constitutionality. We conclude in favor of a percentage contribution bonus set high enough to provide marginally more income for charity and reduce financial uncertainties during the transition. Appraisal of political feasibility suggests that supporters of charity are likely to be worse off unless they come up with a more defensible approach, such as the contribution bonus. To help resolve doubts, we suggest adding on a small percentage contribution bonus to the present tax write-off for three years so as to test constitutionality and assess more precisely administrative costs. While there is no one proposal that will make everyone better off, the contribution bonus is far superior on most criteria to the alternatives.

The tax write-off, the existing method for government support of charitable contributions, is grossly inequitable and limited in the amount that it provides to charity. Our problem is to determine if any other means would be more just, provide more revenue, and maintain the private character of charity.

Is the write-off a rip-off? Not really; few people, so far as we know, actually make money out of giving to charity. If the write-off is in disrepute, how-

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ever, that is easy to understand because the rich are subsidized so much more than the poor. Surely no one today would deliberately set out to create a method of financing charitable contributions that would add, say, 70 percent to the rich man's contribution, 14 percent to the poorer man's, and nothing at all to the poorest. Nor would people with the same gross income be treated differently depending on whether the sources of that income or the status of the person were suitable for the exemptions or not. Except for McDaniel's rather special proposal for the government to make direct grants to charity according to the proportion of income that an individual contributes to that charity,[1] and the rather perfunctory mention of tax credits, there has been little analysis of tax alternatives and none whatsoever of working through the budget process. The federal government could match all or part of citizen contributions for a period of years or in perpetuity with or without limiting the total amounts. Our purpose is to analyze the advantages and disadvantages of both tax and budget alternatives.

In the course of our analysis we shall face three problems that can be discussed (or, occasionally, avoided) but not solved. The first, at least in the short run, is the lack of agreement among experts on essential aspects of taxation: who pays how much with what effect? How are incentives to work or to give to charity affected by various taxes? We cannot enter the exotic (though important) disputes over how certain costs ought to be apportioned among classes of taxpayers. Our judgments about the burden of taxation will, therefore, not be so much argued (it is hard to argue with ignorance) as asserted. But we can try to get around the question of incentives by asking whether we would change our minds about desirable policies if we knew the answer. So we will conduct a sensitivity analysis—would it matter for choice among alternatives if the public subsidy for supporting charity had a 0, 50, or 100 percent incentive effect? Maybe we don't need to know what we can't find out. Let us hope so because the other two problems—the "appearance" versus the "reality" of the charitable tax write-off, and the existential nature of the "true" budget and tax systems—are essentially philosophical. Answers to these questions depend on how one looks at them. One can be consistent but not necessarily correct.

The real reality may well be the apparent appearance; form often influences content. It is said that the United States Government has a progressive income tax. Is that the real tax system or is it a would-be progressive tax as modified by innumerable exceptions? The budgetary process is usually described as resource allocation by the President and Congress through its appropriations committees. Is that the real budgetary process or is it that process together with numerous provisions for "backdoor" spending through direct drafts on the Treasury, low-interest loans, and other devices? From a behavioral or descriptive point of view actual practices constitute the real system. If the exceptions are part of the rule, however, then the tax write-off for charitable deductions stands in a better light. Then the government is not contributing or losing income but legitimately excluding certain private activities from being considered as income. Unless whatever is is right, however, tax and budget reformers will object to sanctifying regretable lapses as operating principles. To them the real systems are the ones we ought to perfect—a progressive tax on income whose revenues are allocated at the same time through the same public mechanism. And the present system of tax write-off interferes with both these ideals. Some argue that there are matters (of which government support of charity is one) that should not be subject to normal political processes. The write-off or any other tax mechanism is preferred over an expenditure device precisely because it hides more than it reveals. What guarantee can there be, the advocates of tax mechanisms argue, that a direct expenditure will not be an invitation to indirect control over charity?

None. We give no guarantees, but our denial is broader than their's. So long as government subsidizes charity, we believe, the potential for government control is there. What is more, that potential is now growing as the tax system comes under ever greater criticism. If charitables are to escape the horns of this dilemma they must develop new alternatives for governmental support for charity. The place to look is the budgetary process, for if tax devices have been given some consideration, budget mechanisms have been largely ignored.

I

BUDGET ALTERNATIVES

If government support of charitable contributions was to be financed through budget rather than tax mechanisms, which types of expenditure would be most appropriate? Each budgetary device comes with a different set of conditions. Whether the amount of money is fixed by the government or flows automatically as a consequence of action by givers, whether the money is available for a single year or for many years or until the legislation is changed, all depend on the particular device that is used. The type of budget provision affects monetary considerations not only directly but also indirectly because of its association with a particular pattern of decision making. How the money comes determines who will be giving it. Under some provisions the money goes through the appropriations committees, while under others it passes only through some legislative committee. And the kind of committee considering the matter in Congress is also likely to determine the executive branch agency that will be in charge of charity. A lot is at stake in choosing the form of financing—who will get how much under what conditions.

There is more than one budgetary process. The classical types, which we usually think of as budgeting, begin with an authorization to spend by a legislative committee and go on to obtain permission to spend through the appropriations committees. Let us simply call this *appropriations budgeting*.

The second process begins with a mandate to spend from the Treasury (through trust funds, loans, or direct disbursements), originating with a legislative committee, going directly to the floors of the houses of Congress but not stopping at the appropriations committees. Let us call this *treasury budgeting*.

What would happen if the federal government financed its portion of charitable contributions through appropriations or treasury budgeting? Let us start with the strictest possible regimen—annual authorizations and single-year appropriations. Presumably the purpose of such a device would be to encourage frequent consideration of how much the government should give to what particular charitable purposes. Immediately political and constitutional problems that do not now exist would be created. Treating religious organizations differently than others would run afoul of the constitutional provisions and court rulings on separation of church and state. The executive and legislative branches would have to take positions on which charities or charitable purposes were more desirable than others. While it is not possible to say with certainty which executive departments and congressional committees would have jurisdiction, a likely result of emphasizing the substance of charitable allocation would mean lodging the task in the Department of Health, Education and Welfare whose jurisdiction covers the largest part of philanthropic endeavor outside of religion. Naturally the new Bureau of Charities (Would "Philanthropies" sound better?), like all other bureaus, would be asked to make its recommendations part of overall departmental activities and objectives. Charity might come to be looked at as a supplement to whatever was felt lacking in hospitals or schools or mental health services. Federal contributions might well be seen as a lever to direct larger amounts of private money in desired directions, thus "freeing" other departmental funds for different purposes.

The early life of the bureau and its authorizations and appropriations are bound to be volatile. The celebrated incrementalism of the federal budget process refers to small departures from an existing base and not to the initial negotiations of those shared understandings about the level at which programs ought to be financed. While it is possible that existing federal contributions through the tax write-off would be taken as equivalent to a budgetary base, it is more likely that the matter will be subject to a fundamental reconsideration. No doubt the total amount would settle down after a few years but it might be hard for charitable organizations to live through the transition. As a new activity, sponsored by a new bureau, charitable appropriations would be subject to closer control and would be more vulnerable than its older competitors to periodic economy drives and reductions in force. Since the total amount would be within the annual discretion of Congress and the executive, charitable appropriations might be asked to play their part in economic management, meaning greater or lesser expenditures as the times appear to dictate.

While this "parade of horribles" might be somewhat exaggerated, we think it is not far from the truth. While the Bureau of Charities would undoubtedly wish to raise the total amount of governmental contributions, it could only do so by promising programmatic results through direction of the monies. Yet, if there is any principle one would suppose should apply to charitable giving, apart from allowing the giver to direct his money as he chooses, it is that whatever rules, forces, and objectives guide government policy should be different on the charitable side. Otherwise, it would become evident that charities are merely a convoluted way for government to carry out activities that it is already doing or that it would like to do.

Apparently, with the annual authorization and appropriation alternatives, charitable endeavors will have hit rock bottom. Suppose the next move is to multi-year authorizations and single-year appropriations. One set of committees would be eliminated for the next few years after the first authorization, but the appropriations committee would still have to come up with a particular sum every year. Since these committees are often advised not only to say "how much" but to ask again "what for," there could be no guarantee that the initial authorization would be met or that the appropriations committee would not impose restrictions on the object of expenditure or that in order to gain support the Bureau of Charities might not do the same. Some certainty would probably be gained but not very much.

Predictability could substantially be improved by going to both multi-year authorizations and appropriations. However difficult the initial funding decisions might be, charitable organizations would know how much they were going to get from the government for at least three to five years. The political battle would be periodic, not continuous.

For the charitables the best alternative would be permanent authorizations and appropriations. At this point appropriations budgeting is left behind and treasury budgeting takes over. While the initial period of decisions might be difficult, once the total amounts were set they would go on in perpetuity unless there were a specific action to change them. There would be no need for a new government bureau or for treating religion differently than other charities. Governmental direction of charitable contributions should be no greater than it is now. And tax and budget reform would be served by clearly identifying expenditures as such. This would not be the end but only the beginning of the story, however, for everything would depend on the precise mechanism for paying out money: should the subsidy be open-ended, operate within a fixed total, go directly to the charity, or back to the individual donor?

Under the best of all possible worlds for charitables, Congress would agree to an open-ended entitlement under which it would augment private contributions to the charities by an agreed-upon percentage of each donor's contribution. No doubt, Congress would have a certain range in mind so that total contributions to charity would be neither too large nor too small. Of course, Congress, like Goldilocks, could be wrong and charities could be left with less money than they have had in the past or with far more than Congress was really willing to spend. Then Congress would have to change the original legislation by altering the percentage at which the government supplemented private contributions. While government would, in essence, be shaping the total amount, it would not be interfering with the relationship between the donor and the recipient.

Under this open-ended arrangement for supplementing private contributions, the chance for significantly increasing the government's contribution to charity would be greatly enhanced. Even if the government contribution was on the large side, it might appear mean or niggardly or not worth the bother to fiddle with the system so as to reduce it by another billion or two. And the opportunities for playing the supplementing game would be wondrous to behold.[2] Today cities and states with matching grant programs have learned that not only direct financial contributions but donations of employee time and effort may be counted toward their contribution. If the free labor donated to charities could be valued at a certain dollar amount and if it were deemed appropriate for a supplement, the government's contribution could easily rise by 200 percent or 300 percent. Obviously, the size of the federal budget would be noticeably increased.

The next move, assuming open-ended arrangement for supplementing private contributions got out of hand, a not unlikely occurrence, would be supplementing under a fixed amount. Each individual contribution would then be supplemented at a proportion, which taken in total, would add up to the number of billions Congress had in mind. Donors would not know precisely the level at which their contributions would be supplemented but after a time, experience should give them a pretty good guide. However, the effects of public matching on private contributions require a word of warning. Should the government decide to supplement individual giving so that the total of public and private contributions would reach a certain level, it would be engaging in a self-defeating enterprise. Once the governmental contribution is limited, however, private efforts can only add to the total. Reduced giving might mean that the government supplemented at a higher percentage the donations of those who contributed, but the sum going to charities would still be less than if these individuals had maintained their efforts.

The 1973 reform of budget procedures contains elements which, if followed, would affect any proposal to make government contributions to charity outside of the tax system. First, Congress requires the annual accounting of tax expenditures, and expenditures for the tax write-off will be included in the preparations of the fiscal 1976 budget. Second, under the reform, Cngress passes an initial resolution establishing a ceiling on total expenditures and dividing them up among the various authorizing and appropriating committees. As one means to control backdoor spending, the law places certain limits on new entitlement programs. As soon as an authorizing committee seeks to establish a new entitlement program, the bill would be referred to the appropriations committee if the amount proposed by the authorizing committee exceeded the initial allocation set after the adoption of the first congressional budget resolution. There is no chance that large new expenditures under a new formula would bypass the new budget committees. Since charitable expenditures are not now under the jurisdiction of any authorizing committee, and no committee would want to have another four to six billion dollars suddenly added to its quota, a new arrangement would evidently have to be made. Charitable expenditures from the past would have to be included in the quota given to the House Ways and Means Committee (which had jurisdiction over tax write-offs), or some entirely new arrangement would have to be made by the House and Senate budget committees. This new arrangement might well include original jurisdiction for the new budget committees, since they could combine concern over totals with lack of interest in details of governmental contributions to charity.

If a fixed-sum multi-year appropriation device were adopted for charitable contributions, the newly established budget committees might play a useful role. They, rather than Ways and Means, or Finance, which ordinarily handle tax matters, would be the proper place to decide how large or small the government's contribution would be. And a small office in the Treasury or the Office of Management and Budget would be the appropriate administrative agency to make recommendations to Congress on the level of financing. Past complaints about the Treasury tax people being unconcerned with charity were partially misplaced—the less they care about who the money goes to for what purpose the better. But there does need to be some consideration of total amounts and administrative mechanisms for payments, and it would be useful to have an office for these purposes.

What is the likelihood, a concerned charitable might ask, that Congress would go along with a multi-year appropriation? "Mighty slim" would have been the answer in the past. But now members of the appropriations committees have expressed willingness to give up annual review in selected cases. The reason is that treasury budgeting, promoted on grounds that stability in funding is required, threatens to undermine the appropriations process. The new budget reform is one response to this challenge. Another is undermining the rationale of "backdoor (Treasury) spending" by providing the needed stability through the front door of appropriations.

The question of how the government contribution would be dispensed remains to be answered. Charitable organizations could submit a certified list of the contributions received and have it supplemented at the going rate; or individuals might submit lists of their contributions and have a certain proportion directed to charities. Either way, larger administrative expenses would be required. This is especially the case because individuals who make contributions but are outside the tax system, or who take standard deductions, would be included under any supplement scheme. But now we have left budgeting and gone on to other criteria for judging alternatives through which to finance philanthropy. The time has come to state our criteria and apply them to alternative ways of supporting charity through government.

II

PROPOSALS, CRITERIA, AND CONSEQUENCES

The principal means for government support of charity is the tax write-off. Contributions to charitable organizations can be deducted from an individual's taxable income. Two proposals, one a tax expenditure and the other a budget expenditure, have been suggested as alternatives to the tax write-off. The tax expenditure takes the form of a tax credit and is a long-standing proposal having been suggested almost in passing by Kahn in 1960.[3] It gives a fixed rebate to taxpayers for each dollar they give to charity. More recently, McDaniel has proposed a budget expenditure in the form of a sliding matching grant.[4] The percentage of the federal match increases on a sliding scale as the proportion of one's income given to charity increases. The percentage of the federal match ranges from 5 percent for those giving 2 percent of their incomes to charity to 50 percent for those giving over 10 percent of their incomes. To these two alternatives, we have added a third, a budget expenditure, in which charitable organizations receive a government supplement as a fixed proportion of the private contributions they receive. We call this alternative the "donor directed automatic percentage contribution bonus" (or "percentage contribution bonus" or just "bonus" for short) because the government adds to each dollar contributed to a charity. Are these alternatives better or worse than the existing tax write-off as a method for public support of private charity? No one can say because there has never been a comparative analysis of the leading alternatives.

We describe the consequences of each of the four alternative proposals—tax write-off, tax credit, contribution bonus, and the sliding matching grant—in terms of a number of criteria which encompass critical issues related to government support of philanthropy. While we cannot demonstrate that our criteria are better than any other set that might be applied, we hope to persuade the reader that they are plausible and appropriate. And while people will undoubtedly differ as to which criteria deserve priority, we shall try to convince others that the criteria that matter to us ought also to matter to them.

The initial criteria are those which determine whether the charitable enterprise can be carried on at all. Of these, the first is targetability—the ability of private donors to give their money to the charity of their choice. Otherwise private charity would be public, and there would be no reason why whatever criteria apply to government expenditure in general should not also be valid for this class of expenditure in particular. It would be better for government to contribute nothing than to control everything. Constitutionality is also critical. If an alternative is found to contravene separation of church and state, it would not only violate deeply held and widely shared values, it would also be declared null and void.

Our middle-level criteria can be described in terms of more or less rather than all or nothing. Charity can be more or less certain or equitable and still be charity. These criteria raise questions of trade-offs—how much certainty for charitables versus how much controllability for government. Thus, we group the criteria by the major interests concerned with them—donors, charitables, and government.

Donors, in our view, are most affected by pluralism, equity, and reciprocity. The more donors whose contributions are subsidized by the government, the more pluralistic the policy alternative under which government acts. The greater the extent to which each donor's dollar is treated equally by government, the more equitable the policy. The less the donor's contribution is affected (or afflicted) by evident self-interest, such as tax advantages, the more the donor can expect the recipient to reciprocate.

Charitable organizations are concerned with the total amount they receive, its predictability, and its distribution among them according to major purpose. The question of how each alternative for governmental support of charity affects the incentive of donors to give is subsumed under the criterion of total amount. No one would be interested in incentives unless they affected how much was contributed. It is the government that should be worried about the incentive because its money is being used to generate additional private contributions.

The government is concerned about the controllability of the subsidy it gives to charity, the efficiency with which that money is employed, and the legitimacy of the institutional processes it uses to distribute the money. Views about how much government money should go to charity will undoubtedly vary with time. But the government has a permanent interest in being able to determine what that amount will be. Under efficiency, the government is concerned with two distinctly different uses of its money. One is the cost of administering the program—administrative efficiency. The other is the incentive effect its money has in encouraging private donations—allocative efficiency. Legitimacy requires further elucidation.

The government has an interest in managing its affairs so as to inspire citizen confidence. When citizens feel that they are fairly treated, that confidence is enhanced. When citizens see that governmental processes are performing their appointed tasks in an open and straightforward manner, their respect is maintained. Any governmental procedures may be judged, then, on the degree to which they inspire citizen confidence that activities are being performed in a legitimate way. People who make money, for instance, should be seen to pay taxes appropriate to their income. Whether something can be done is an integral part of whether something will get done. An alternative must be politically feasible, or otherwise our best laid plans will come to naught. But political feasibility must not be the sole determinant which drives our analysis; otherwise we merely examine what is possible at the expense of prematurely forfeiting what might be best. An assessment of political feasibility will assist us in determining the desirability of means and in guiding desirable means to productive ends.

Tax Write-off

The tax write-off decreases the charitable donor's tax bill by reducing his liability depending on the tax bracket he is in. The major charge leveled at the tax write-off is that it leads to substantial inequities amongst income groups. The inequities stem from two factors. First and foremost, the tax write-off is worth more to the high-income person than the low-income person. Its value increases in direct proportion to the marginal tax rate. A person in the 70 percent tax bracket can reduce his tax bill by an amount equal to 70 percent of his contribution. This is tantamount to the individual writing a $30 check and the government kicking in $70 to the selected charity. In contrast, a person in the 14 percent tax bracket must pay $86 to his charity to get the government to contribute $14. The high-income person receives, in effect, $2.23 for every dollar, whereas the low-income person receives only $0.16.

For the amount contributed to charity, high-income persons receive a disproportionate share of tax expenditures in the form of reduced tax bills. As Table 1 indicates, in 1970 people with high incomes (over $100,000) contributed an average of slightly over $13,600, reducing their taxes an average of over $11,000. Low-income people (under $5,000) contributed an average of $209, reducing their taxes an average of only $9. Although the average high-income person gave 65 times more than the average low-income person, the average high-income person received a tax reducton which was 1250 times larger than that received by the average low-income person.

Second, the tax write-off provides no benefits for those who take the standard deduction and for those outside the tax system who do not file returns. These people are poor or near poor. In 1972, 86 percent of the non-itemizers taking the $2,000 standard deduction had adjusted gross incomes below $5,000. The non-filers also contained a large proportion of low-income people, primarily those with incomes too low to be taxed. The benefits to both groups were not merely low; they were nonexistent.

Table 1

For the Amount Contributed to Charity, High-Income Persons Receive a Disproportionate Share of Tax Expenditures

Adjusted Gross Income	Number of Persons Taking Write-Off	Government Tax Expenditure (thousands)	Total Contribution	Average Tax Expenditure Per Person	Average Contribution Per Person
Under $5,000	3,910,667	$ 35,000	$ 817,610	$ 9	$ 209
$5,000-$10,000	10,937,788	319,000	2,739,605	29	250
$10,000-$15,000	10,206,268	503,000	3,203,956	49	313
$15,000-$20,000	4,815,864	416,000	2,000,226	86	415
$20,000-$50,000	3,297,556	771,000	2,362,016	234	716
$50,000-$100,000	339,736	426,000	748,482	1,254	2,236
Over $100,000	75,715	855,000	1,020,839	11,291	13,615
Total	32,669,067	$3,325,000	$12,892,734		
Average Per Person				$ 102	$ 395

Estimates based upon data from the United States Internal Revenue Service, Statistics of Income—1970 Individual Tax Returns, Washington, D.C., Government Printing Office, 1972, p. 120; and Annual Report of the Secretary of the Treasury on the State of Finances for Fiscal Year Ending June 30, 1973, "Estimated distribution of selected items of tax preferences of individuals by adjusted gross income, calendar year 1971," pp. 349-354.

Inequities in the opportunity to contribute to charity have impact upon other values which are basic to philanthropy. Pluralism is cited as a cornerstone of philanthropy. The belief that multiple approaches are better than unitary approaches, the belief that voluntary action unencumbered by the rigidities of government or unrestricted by the profit motive of the private sector can lead to creative solutions to social problems, the belief that private individuals can best direct their own assets to meet social needs, these beliefs are all central to philanthropy. But the tax write-off is not consistent with pluralism through philanthropy. The pluralism of the tax write-off is not plural; benefits are largely confined to upper-income groups. What is worse, the write-off is part of larger series of special provisions that have brought the tax system into disrepute.

Legitimacy is central to political institutions. Watergate has visibly demonstrated that not only must a President be legitimate, but he must also appear to the people to be legitimate. Appearance must be the vehicle for expressing the reality of legitimacy. The tax write-off substantially reduces the appearance of (and hence it erodes the basis of) legitimacy. By allowing some individuals to substantially decrease their tax bills by means of charitable contributions, public confidence in the fairness of the tax system is diminished.

In philanthropy, reciprocity is an important factor in linking donors and recipients. If giving is to be sustained, reciprocity must exist between the donor and the recipient. If giving is not to deteriorate into either exploitation of the donor over the recipient or mere market exchange between the donor and the recipient, then reciprocity must exist. Whether one reciprocates and how one reciprocates is affected by how one perceives the motives of the donor.

Largely because each donor faces different tax incentives and because these incentives are not explicit but are hidden within the intricacies of the deduction system, the recipient has much difficulty in accurately deciding why he was given the gift. In philanthropy, it is not uncommon to hear the recipient asking the basic question, "Are they really trying to help me or are they more interested in getting their tax advantages?" The tax write-off serves to obscure the donor's motives from the recipient and in so doing, it does not encourage but, rather, discourages reciprocity.

Supporting charity through the tax system also increases the amount of government expenditures that are not controlled by Congress. The tax write-off is truly uncontrollable. It is not subject to annual or periodic congressional review and, within the tax system, there is no limit on how much a taxpayer can receive. The subsidy is concealed. Neither reform of taxation nor of budgeting is furthered by treating an expenditure as a tax deduction.

The financial inequity inherent in the tax write-off has been widely recognized;[5] less known but equally damaging are its denial of a broad form of pluralism, its erosion of the legitimacy of our tax institutions, and its inhibiting effects on reciprocity. Taken together these are formidable defects. But these alone do not provide sufficient grounds for doing away with the present system. One must ask whether other alternatives are superior. Perhaps, despite its deficiencies, the write-off brings benefits that cannot be obtained by other methods. What benefits are gained from inequality of opportunity to give to charity?

A possible rationale centers on the efficiency of the government subsidy to encourage philanthropic contributions. If the current distribution (among various income groups) of the government tax write-off provides a substantial incentive for contributions, then this inequity may be necessary to raise funds. What does the empirical evidence reveal? For every dollar in tax expenditures (revenue foregone by the Treasury), how many additional dollars are contributed to charity?

The evidence is far from conclusive. But four studies by Taussig, Schwartz, Brannon, and Feldstein are relevant.[6] As each author and his critics point out, these studies are substantially burdened with limitations which qualify the conclusions. But since the studies are the best available, they are instructive. Taussig finds that the efficiency is near zero, approximately 5 percent. Therefore, for every $1.00 reduction in the Treasury, charitable contributions increase by $0.05. Feldstein finds that the efficiency exceeds 100 percent; the write-off increases the amount received by charities by slightly more than the reduction in revenue to the Treasury. Schwartz and Brannon find the efficiency of the write-off to lie between the estimates of Taussig and Feldstein. If we assume the worst of all possible worlds—the tax write-off is totally inefficient—then the inequities in the opportunity to contribute cannot be condoned. If we assume the best—the tax write-off is 100 percent efficient—then the inequities may be condoned, but only if there is no other feasible alternative which does not have these inequities and is equally efficient.

The tax write-off involves only small administrative costs to the IRS and the taxpayer and no administrative costs to the charitables. For itemizers, contributions are listed, receipts appended, forms filed, calculations made, and tax bills reduced. For non-itemizers, standard deductions are taken, calculations made, and tax bills reduced. All this is done as part of the standard operating procedures of the income tax system. Administrative simplicity is a key virtue of the tax write-off.

While supporting philanthropy (and this inevitably includes religious organizations), the tax write-off has not so far offended the constitutional requirement for separation of church and state. Largely because the government subsidy to philanthropy is directed to the contributor and remains concealed within the tax system, the constitutionality of the tax write-off has not been and is unlikely to be seriously challenged.

The Tax Credit

The credit works through the income tax system by returning to each charitable donor an amount equal to a percentage of his contribution. The tax credit is substantially more equitable than the tax write-off. An individual's marginal tax rate no longer dictates the size of the government subsidy that he receives. Since all taxpayers itemizing their contributions receive a fixed percentage of their charitable contribution in the form of a tax credit, the size of the contribution is the only important variable. For a $100 contribution, the lower-income person receives the same tax credit as the higher-income person. But those taking the standard deduction receive no tax credit. In 1972, this group amounted to two thirds of all taxpayers, and nearly all of them had incomes below $15,000. In addition, those outside the tax system, often the very poor, receive no tax credit for their contributions. But, despite these limitations, the tax credit does eliminate inequities within the group of those itemizing charitable contributions. Thus the tax credit expands pluralism, enhances legitimacy, and strengthens reciprocity, but backdoor spending through the tax system is not eliminated. Uncontrollables remain uncontrollable. Reciprocity improves as philanthropic motives for giving are not entirely obscured by differential tax advantages.

The administrative simplicity of the write-off is maintained by the tax credit. Once the reimbursement rate is established, the IRS can issue tax credits as easily as reduce taxable income. But we don't get something for nothing. What are the costs of reducing inequities? Who incurs these costs? Charities can hardly get more, and there is reason to believe they might get considerably less. Assume the government had implemented the tax credit in 1970 and had been willing to expend the same $3.3 billion in credits as it did on tax deductions. Since tax itemizers gave a total of $12.9 billion in that year, the average government subsidy would be about 35 percent.[7] As a result, those who under a tax write-off received a 35 percent matching subsidy would likely continue to contribute the same with a tax credit. Repeal of the write-off and enactment of the tax credit *increases* the government subsidy for all those who are in a tax bracket below 35 percent. On the other hand, the government subsidy *decreases* for all those in the brackets above 35 percent. If the tax credit is to maintain a flow of charitable contributions at least equal to the write-off, then any decrease in contributions by the wealthy must be compensated by increases in contributions from the poor. Is this likely to happen?

It depends upon the overall incentive effects of the tax write-off and the tax credit. If the tax write-off has no effect on contributions, then as long as the tax credit has no negative or disincentive effects, total contributions will be maintained. But what happens if the tax write-off has substantially different effects on different income groups? What happens if the tax write-off has no effect on the contributions of the low- and middle-income persons, those below the 35 percent tax bracket, and a 100 percent incentive effect on the wealthy, those above the 35 percent tax bracket? The charitables lose. For if the incentive of the tax credit remains at zero for those under the 35 percent tax bracket, their contributions will remain the same, whereas maintenance of a 100 percent incentive effect under tax credit for the wealthy will mean decreases in their contributions. To maintain the current level of total contributions under a tax credit, therefore, the low and middle incomes must pick up the slack left by the wealthy. Yet they may be reluctant to fill the contribution vacuum because they already feel overburdened or fail to see they are better off, or from just plain inertia.

Not only may the total flow of philanthropic contributions be reduced by a tax credit but their internal distribution is likely to be affected. Different income groups give to different philanthropic organizations. Under a tax credit more will be given to the charities of the lower income (for example, religion) and less to those preferred by the wealthy (education, museums, orchestras, and so forth). How many are called also affects who will be chosen.

A tax credit will afford the government greater opportunity to fine-tune the extent of its support of philanthropy. Under the tax write-off, the subsidy is tied to the existing rate structure, whereas a tax credit is only affected by the government's reimbursement rate. Tax rates on all incomes would be harder to change than reimbursement rates. So, for charities, the write-off would be more predictable than the tax credit.

Percentage Contribution Bonus

Under the contribution bonus, the federal government makes a direct expenditure to a charitable at a fixed proportion of the amount voluntarily contributed by an individual. The bonus has a number of advantages over the tax write-off and tax credit because the government subsidy is made directly to the charitable organization at the initiative of the contributor. The significance of this in terms of equity, efficiency, and total contributions can be illustrated by examining the distribution of private and public costs for the write-off versus the bonus. In 1970, the Treasury allowed taxpayers to write off

$3.3 billion in taxes. Individuals made $12.9 billion in charitable contributions. Another $1.5 billion was contributed by those taking the standard deduction, thus making a total of $14.4 billion in individual contributions to philanthropy. Table 2 illustrates (by income class for contributors) who got how much of the government subsidy, who contributed how much of the private cost of philanthropy, and who contributed how much to the total amount of philanthropy.

In short, the rich as a group (over $50,000) represent about 1 percent of the total contributors, pay 5 percent of the total private costs ($0.5 billion), give 14 percent of the total charitable contributions ($1.7 billion), but receive 39 percent of the government write-off ($1.3 billion).

Table 3 indicates the consequences of repealing the tax write-off and instituting a 35 percent bonus. With repeal of the tax write-off and enactment of the contribution bonus, we assume that all contributors will give at a level equal to their private costs under the tax write-off. A wealthy person in the 70 percent tax bracket who gave $100 under the tax write-off will under the contribution bonus reduce his contribution to $30, a person in the 14 percent tax bracket will reduce his contribution to $86; non-itemizers and those outside the tax system will contribute the same amounts. The contributions of every individual generate a 35 percent bonus. The wealthy person who gives $30 of his own money will generate a bonus of $10.50 from the government. The flow to the charity (private contributions plus government bonus) will be $40.50. The poorer person will give $86 of his own money and generate a $30 bonus from the government. The flow to the charity will be $116. The non-itemizers who gave $1.51 billion in 1970 will generate a 35 percent bonus resulting in a flow to charities of $2.01 billion. Likewise, the 35 percent bonus will increase (no one knows how much) the contributions made by those outside the tax system.[8]

The total flow to charitables of $12.9 billion generated by the itemizers is the same with the contribution bonus as it is with the tax write-off. The cost to the government of the bonus is the same as the write-off—$3.3 billion. As equity is further extended to non-itemizers through the contribution bonus, total flows to charitables will increase to $14.9 billion as compared with $14.4 under the tax write-off. This, of course, requires an extra $0.5 billion from government to match the contributions of the non-itemizers. Total charitable flows would increase further as the contributions of those outside the tax system receive a bonus. The flow of contributions to charitables is maintained and most likely increased.

We have assumed that all individuals will reduce their charitable contributions by the amount equal to the government subsidy which they now receive under the tax write-off. This assumption is critical to the consequences that we have found. Have we, then, loaded the dice in our favor? No, we have assumed the worst, for if the tax write-off has a 100 percent incentive effect on contributions, then the percentage contribution bonus must equal the largest amount produced by its competitor. Since repeal of the write-off might mean a decrease in charitable contributions of $3.3 billion in 1970, a contribution bonus of at least that amount should ensure that the total flow to charitables will be maintained.

It should, but it might not; despite assumptions that seem safe to the analyst, people do not always behave the way he thinks they will. Reason is not always right. Suppose certain individuals give less than their private costs without the slack being taken up by others; or, despite current evidence, that the tax write-off is substantially more than 100 percent effective; or that the enactment of the percentage contribution totally "turns off" a number of large contributors so that they give nothing to charity. For these expected contin-

Table 2

The Tax Write-Off: The Rich (1% of the Contributors) Pay 5% of the Total Private Cost ($0.5 Billion), Give 14% of the Total Charitable Contributions ($1.7 Billion), but Receive 39% of the Write-Off ($1.3 Billion)

(1970 contributions in thousands of dollars)

Adjusted Gross Income Group	Number in the Group	Private Cost of Contribution[a]	Government Subsidy (tax write-off)[b]	Total Flow of Contributions to Charities[c]
Under $5,000	3,910,667	$ 782,610	$ 35,000	$ 817,610
$5,000-$10,000	10,939,788	2,420,605	319,000	2,739,605
$10,000-$15,000	10,206,268	2,700,956	503,000	3,203,956
$15,000-$20,000	4,815,864	1,584,226	416,000	2,000,226
$20,000-$50,000	3,297,558	1,591,016	771,000	2,362,016
$50,000-$100,000	339,736	322,482	426,000	748,482
Over $100,000	75,715	165,839	855,000	1,020,839
Total for tax itemizers	32,669,067	$9,567,734	$3,325,000	$12,892,734
Total for non-itemizers				1,510,000
Total individual giving				$14,402,734

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a. Private cost is calculated by subtracting the government subsidy from the total contributions for each income class.

b. Estimates from *Annual Report of the Secretary of the Treasury on the State of Finances for Fiscal Year Ending June 30, 1973*, Government Printing Office, Washington, D.C., 1973. See Appendix D, "Estimated distribution of selected items of tax preferences of individuals by adjusted gross income class, calendar year 1971," pp. 349-354.

c. Based upon data from the United States Internal Revenue Service, Statistics of Income—*1970 Individual Tax Returns*, Washington, Government Printing Office, 1972, p. 120.

Table 3

The 35% Contribution Bonus: An Equitable Government Subsidy and Maintenance of the Total Flow of Charitable Contributions

(1970 contributions in thousands of dollars)

Adjusted Gross Income Group	Number in the Group	Private Cost of Contribution[a]	Government Subsidy 35% Contribution Bonus[b]	Total Flow of Contributions to Charitables[c]
Under $5,000	3,910,667	$ 782,610	$ 273,913	$ 1,056,523
$5,000-$10,000	10,939,788	2,420,605	847,211	3,267,816
$10,000-$15,000	10,206,268	2,700,956	945,332	3,646,282
$15,000-$20,000	4,815,864	1,584,226	554,479	2,138,705
$20,000-$50,000	3,297,558	1,591,016	556,856	2,147,872
$50,000-$100,000	339,736	322,482	112,868	435,350
Over $100,000	75,715	165,839	58,043	223,882
Total for itemizers	32,669,067	$ 9,567,734	$3,348,702	$12,916,430
Total for non-itemizers		1,510,000	503,333	2,013,333
Total individual giving		$11,067,734	$3,852,035	$14,929,763

a. The private cost of the contribution for each income group is assumed to be the same under the percentage contribution bonus as under the tax write-off.

b. The government subsidy which is directed by each income group is calculated by taking 35 percent of the private cost of the contribution for that income group.

c. Based upon data from the United States Internal Revenue Service, Statistics of Income, 1970 Individual Tax Returns. Washington, Government Printing Office, 1972, p. 120.

Assumption: It is assumed that with repeal of the tax write-off and enactment of the percentage contribution bonus, that all contributors will give at a level equal to their private costs under the tax write-off.

gencies and for others that might be unanticipated in transition from the tax write-off to the contribution bonus, it is advisable to increase the percentage bonus to, say, 38 percent. The total government subsidy would be $3.6 billion, costing the government and the taxpayers $0.3 billion more but it would also guarantee at least the same flow of contributions to charitables. Their inducement for trying something new is a little more hedge against uncertainty.

Legitimacy is enhanced and pluralism broadened through the contribution bonus. Charitable tax loopholes are driven from the tax system and backdoor spending now passes out through the front. Reciprocity is likewise encouraged. The donor's contribution is a clear expression of his philanthropic feeling for the recipient. The government subsidy is above board.

But the contribution bonus has three inherent problems related to (1) administration, (2) constitutionality, and (3) the certainty in the flow of total philanthropic funds. The third has already been discussed within the section on budget alternatives. Annual authorizations and appropriations mean great uncertainty for charities whereas multi-year authorizations and appropriations substantially reduce the uncertainty. The first two matters will now be examined in this section.

The contribution bonus brings higher administrative costs to the government and the charitables. Although a detailed administrative system cannot be set forth in this paper, a possible approach could take the following form. The donor would make his contributions to his selected charitables. Charities would total their income and report to the government, which would periodically issue checks containing their percentage contribution bonus. Periodic audits would, of course, be made to verify the accuracy of the reports.

The government may be unable to make the necessary calculations so that each charitable organization can receive its new bonus at the same time as it received its old private contributions. But just as government makes quarterly appropriations to its agencies so that they can maintain a steady flow of revenues, the government might pay out to each charitable a proprotion of its past bonus in advance of calculations. Then, after charities submit their totals and audits are made, the rest of the money can flow in.

Although this system decreases the administrative cost to the donor, since he no longer has to itemize deductions and attach receipts when filing income taxes, it increases administrative costs to the government which must process incoming certification forms, calculate the percentage bonus, periodically issue checks to the charitables, and monitor a selected number of donor-recipient transactions to ensure that abuses do not occur. But the magnitude of this cost will be slightly reduced since charitable deductions are eliminated in calculating taxable income. The charitables will also incur increased administrative expenses; additional form filling will be required to ensure receipt of the federal bonus. Still, the charitables have the main incentive to record all there is and they can be expected to do so. It is the government that is faced with directly allocating funds to charity where previously the funds had emerged, as it were, untouched by human hands.

The contribution bonus raises a perplexing constitutional obstacle—the separation of church and state. While the issue cannot be fully addressed within the confines of this paper, a few comments are in order. No doubt, the form of a tax write-off for a donor is substantially different than a contribution bonus to a parish. But the write-off and the bonus have a significant and fundamental characteristic in common. Neither is initiated or directed by the state or the church. Instead, the bonus, like the write-off, can only be triggered by the donor. The bonus, like the write-off, supports the voluntary initiative taken by the charitable contributor. No amount of governmental discretion in terms of who will receive how much is required. The Supreme Court decision to uphold federal grants to church-related colleges for construction, but to forbid any grant for construction of facilities "to be used for sectarian instruction or as a place for religious worship"[9] may not be as directly relevant here as Bittker would wish us to believe.[10] For the facts in this decision indicate that the federal grant is initiated by the religious institutions and administered by a government agency. In contrast, the contribution bonus is not a grant in the normal sense of the word, for power to initiate it lies not with the government, nor with the church, but solely and exclusively with the charitable contributor. Church and state are separate. Or so we think, but no one can guarantee the courts will uphold our logic. The percentage contribution bonus ought to be constitutional, but it may not be.

Sliding Matching Grant

To date, the only matching grant scheme which has been put forward in the literature is a special proposal calling for the government to match individual contributions in proportion to the percentage of income contributed.[11] The government match slides in response to the proportion of income contributed. This proposal will not be discussed in detail since it is similar to the contribution bonus in terms of the basic problems it solves and the questions it raises. It reduces inequity, enhances pluralism and legitimacy, and improves reciprocity. We will focus on the most significant component of this proposal which distinguishes it from the contribution bonus.

The provision that the sliding matching grant vary according to the proportion of income contributed necessitates the requirement that the administration of the proposal be linked to the filing of income tax returns. Contributions as a proportion of income must be calculated by the IRS. Therefore, the initiative for declaring the contribution for purposes of generating the government grant rests entirely with the contributor. But the contributor has little incentive to report contributions to the IRS for he no longer receives direct personal benefits in the form of a tax write-off. As a result, not all contributions will be reported, not all matching grants will be made, and charitables are likely to get short-changed!

In addition, as McDaniel notes, to ensure equity for all contributors, the sliding matching grant would require that returns be filed by those outside the tax system and that those taxpayers claiming the standard deduction would be required to itemize contributions. Once again, the personal incentive question becomes critical. If those outside the tax system and those taking the standard deduction do not receive direct personal benefits for their troubles (form filling and filing, itemizing, retaining receipts, and so on), they are unlikely to voluntarily undertake the work to generate the grant for the charitables.[12] At least there will be considerable slippage between contributing and reporting what was contributed.

To overcome the problem of failure to report all contributions, it is conceivable that the charitables could report to the IRS the contributions they have received. But the donors would still have to report their contributions to the IRS through the tax system in order that the government's share could be calculated as a percentage of the proportion of income contributed. This approach appears to involve extremely high administrative costs and may be unworkable.

We also do not see *why* the proportion of the income devoted to charity should occupy a special place of merit in governmental policy. Equity requires that each person be treated equally by the government, not that the government discriminate against those who, for whatever reason, contribute a lower proportion of their income. If effort is to be the criterion, much more would have to be known about each taxpayer than the government could (or should) want to know.

Running through the analysis of each of the four alternatives have been assumptions about the incentives they give to various classes of donors for increasing or decreasing contributions. At first blush the question may appear unworthy of the asker. Is anyone suggesting that altruism is infected with interest? Precisely. Unless people have unlimited amounts to give, the extent of their contribution must be based on how much they can afford as well as how much they would like to contribute. Had the government not entered the game, givers need only consult their own capacities and preferences. But once there is a government subsidy—tax write-offs have been available since 1917—any prudent person would consider how the government's contribution affects his own. It may be more blessed to give than to receive, but the government has long since decreed that receiving is an integral part of giving.

How can we calculate this subtle consideration? It is a little like children asking what would you do if . . . . Without replaying the reel of history, it is not possible to know for certain how people in different income brackets would have behaved if things had been different. Without trying the various alternatives in practice, no one can say for sure exactly what would happen. That is why we need analysis to improve our guess work. One way to proceed is to ask how sensitive each alternative is to different assumptions about incentives for giving.

III

WHAT DIFFERENCE DOES THE GOVERNMENT SUBSIDY MAKE? A SENSITIVITY ANALYSIS

All estimates about the incentive effects of the government subsidy upon charitable contributions have been made on the tax write-off. Four separate analyses have led to three separate conclusions—near zero, about half, and over 100 percent. The substantial divergence in these estimates makes it difficult to draw precise conclusions about the incentive effects. But precise conclusions may be unnecessary. Acceptance of any one of these three estimates may make no difference in choosing among policy alternatives for supporting philanthropy. Our analysis reveals that it does not make much difference which incentive estimate is assumed in the case of the percentage contribution bonus, but it does make a difference for both the tax credit and the write-off.

Let us illustrate these conclusions by examining the consequences of the percentage contribution bonus and the tax credit given various assumptions about the incentive effects of the tax write-off. As shown in Table 4, the tax write-off costing the Treasury $3.4 billion resulted in total flows to charitables of $14.4 billion in 1970. If the incentive effect of the write-off is 100 percent then repeal of the write-off reduces total contributions by the full $3.4 billion. Total flow will be $11.0 billion. If the contribution bonus is instituted with the government share equal to the amount spent under the tax write-off, then the total flow is $11.0 billion plus $3.4 or the original $14.4 billion. If the incentive effect of the tax write-off is only 50 percent, then repeal of the write-off reduces total contributions by one-half of the subsidy—$1.7 billion—reducing total flow to $12.7 billion. Enactment of the contribution bonus increases the total flow by $3.4 billion (adding $3.4 to the new base of $12.7) resulting in

$16.1 billion going to philanthropy. If the tax write-off has no effect on contributions, then its repeal leaves total contributions unchanged at $14.4 billion. Enactment of the contribution bonus increases the total flow by $3.4 billion to a level of $17.8 billion.

What about the tax credit? Table 4 indicates that if the tax write-off has no incentive effect, then its repeal and substitution of a tax credit also with a zero incentive effect leaves the total flow unchanged at $14.4 billion. Within each of these three assumptions we have also assumed that the bonus has no incentive effects of its own. If the bonus does induce additional giving, then repeal of the tax write-off and enactment of the bonus results in increased contributions. Therefore, we conclude for all reasonable assumptions about the incentive effects of the tax write-off and percentage contribution bonus that the bonus will maintain the same or greater total flow to charitables if it is substituted for the tax write-off.

As for the tax write-off itself, its desirability is extremely sensitive to its presumed incentive effect. For if the incentive is really near zero, many of its other advantages, such as low administrative expenses, become meaningless. Obviously, the choice among alternatives should be decided by considering not one but many criteria. While a single fatal defect might be decisive, it is most likely that each of our patients suffers from a series of minor and major maladies. Our task is not to provide a cure-all but to determine the disease with which we are prepared to live.

IV

HOW MUCH OF WHICH PROBLEMS ARE WE PREPARED TO LIVE WITH? A CRITERIA ANALYSIS

We have described four alternative proposals in terms of a number of criteria. If these proposals are to maintain and perhaps enhance the private philanthropic sector, then each proposal must meet the initial criteria of targetability and constitutionality. Each alternative ensures individuals private choice in directing their resources to their preferred charities. Whether public support comes in the form of a write-off, a credit, a bonus, or a matching grant, the donor remains sovereign in determining who receives his contribution. The tax write-off is constitutional largely because the government subsidy is concealed within the tax system and directed to the contributor. The tax credit which alters only the form of the tax subsidy but maintains the protection of the tax system and directly subsidizes the taxpayer, is also likely to be constitutional. But the constitutionality of both the percentage contribution bonus and the sliding matching grant remains uncertain. Without directly testing these instruments, it seems unlikely that their constitutionality can be given an unqualified yes or no. However, because doubt does exist, which can ultimately and only be resolved by resorting to the courts, this is no reason for prematurely dismissing these alternatives on constitutional grounds. It would be like the judge awarding the prize to the second singer having only heard the first.

Our analysis of the alternatives has indicated that no single alternative can be all things to all people. There are trade-offs on the criteria both among the groups who supply charity (the donors, the charitables, and the government) and within them. To analyze these trade-offs and their implications for selecting among alternatives, it is useful to start with what is most desired by each group. Meeting all the desires of one group will affect how well the desires of other groups can be met.

Table 4

Repeal of the Tax Write-Off with a 100% Incentive Effect and Substitution of the Percentage Contribution Bonus with a 0% Incentive Effect Maintains Total Flows to Charitables

Policy Alternatives	Assumptions Re Incentive Effects of Government Subsidy		
	Taussig 0%	Schwartz 50%	Feldstein 100%
		Total Flow to Charitables	
Tax write-off	$14.4	$14.4	$14.4
Eliminate tax write-off of $3.4 billion[a]	14.4	12.7	11.0
Institute percentage contribution bonus of $3.4 billion. Assume incentive effect to be:			
0%	17.8	16.1	14.4
50%	19.5	17.8	16.1
100%	21.2	19.5	17.8
Institute tax credit of $3.4 billion. Assume incentive effect to be:			
0%	14.4	12.7	11.0
50%	16.1	14.4	12.7
100%	17.8	16.1	14.4

Source: Total contribution data are for 1970. Total charitable flows are from Giving USA, 1974 Annual Report. A publication of the American Association of Fund-Raising Counsel, Inc. The Government subsidy is estimated from the Annual Report of the Secretary of Treasury on the State of Finances for Fiscal Year Ending June 30, 1973. U.S. Government Printing Office, Washington, D.C., 1973. Appendix D, "Estimated contribution of selected items of tax preferences of individuals by adjusted gross income class, calendar year 1971," pp. 349-354.

a. Although the government subsidy in the form of a tax write-off is estimated to be $3.325 billion in 1970, we have rounded it to $3.4 billion for ease in computation. This rounding in no way affects our conclusions.

Perspectives: Donors, Charitables, Government

To aid in this analysis, Table 5 provides a summary description of the performance of the alternatives in terms of the criteria as viewed from the separate perspectives of the three groups.[14] Let us start by examining charity from the donor's perspective. The donor is concerned that public support for charity be equitable, pluralistic, and encourage reciprocity. If all these criteria for the donor are to be met, then the government must abandon the tax system as its means of supporting charity. Neither a tax write-off nor a tax credit can be totally satisfactory for the donor. As tax expenditures are replaced by budget expenditures in the form of a contribution bonus, donor equity, pluralism, and reciprocity are ensured. Government legitimacy is enhanced. Since the bonus is directed to the charitable organizations rather than to the donors, government has little concern with allocative efficiency—the incentive effect of its subsidy. The critical test of efficiency is administrative—the magnitude of the administrative costs which are sure to rise with the exact level unknown. Because government subsidizes charity through a budget expenditure, government controllability in determining how much of its money should go to charity increases. But as government has greater leverage over the size of its subsidy, all the concerns of the charitables cannot be met. Although total flow to the charitables is maintained at current levels or perhaps higher, its distribution among charitable organizations is altered. Government controllability conflicts with charitable predictability.

What about the perspective of the charitables? What happens if they are to maintain high flows with high predictability and unaltered distribution among charitable organizations? Then donors suffer in terms of reduced equity, pluralism, and reciprocity. The tax write-off ensures benefits for the charitables but levies costs on the donor. For the government, legitimacy is low, but so are its administrative costs. However, because the tax write-off is a means for inducing donor contributions rather than directly supporting charitables, the test is not administrative efficiency but allocative efficiency. But the incentive effect of the tax write-off remains largely unknown. Therefore, government's allocative efficiency must be unknown. Even if the incentive was found to have multiplier effects, government's limited capability to control the size of the subsidy would render it ineffective in attempting to stimulate further charitable giving. Government is left in a position of having little control over an instrument which may or may not be efficient.

What about the governmental perspective? Suppose government wants to be legitimate, efficient, and control the size of its subsidy. Is this possible? No. If the government is to be legitimate, it can adopt the contribution bonus which ensures controllability but reduces administrative efficiency. If government is to be administratively efficient, it can adopt the tax credit but legitimacy and controllability suffer. In contrast to donors and charitables, there is no single alternative which gives government all it wants. How much of which government criteria should be sacrificed is of crucial importance to charitables if they are to maintain or increase their total flows without substantially reducing predictability or altering distribution.

Trade-Offs

Let us examine how the sacrifice of one government criterion affects the concerns of charitable organizations, donors, and other government criteria. We will start by sacrificing controllability. If government wants to control the size of its subsidy to charity, then the contribution bonus should be instituted.

Table 5
How Much of Which Problems Are We Prepared to Live With? A Criteria Analysis

	Donor			Charitables		
	Equity	Pluralism	Reciprocity	Total Flow	Predictability	Distribution
Tax write-off	low	low	low	high	high	as is
Tax credit	medium	medium	medium	medium	medium	slightly altered
Percentage contribution bonus	high	high	high	high, perhaps higher	medium	slightly altered
Sliding matching grant	medium	medium	medium	high	medium	slightly altered

	Government			
	Controllability	Administrative Efficiency	Allocative Efficiency	Legitimacy
Tax write-off	low	high	unknown, but relevant	low
Tax credit	medium	high	unknown, but very relevant	medium
Percentage contribution bonus	high	medium	unknown, but irrelevant	high
Sliding matching grant	high	medium	unknown, but relevant	medium

If control is sacrificed, a tax credit can be instituted which still means backdoor tax expenditures, but unlike the tax write-off, the size of the subsidy can be regulated by changing the percentage reimbursement rate. Sacrifice in control, however, affects legitimacy and efficiency. Government cannot be legitimate, for the tax system conceals the government expenditure and excludes non-itemizers and non-filers from tax benefits. Its negative effects on donors and charitables, moreover, are substantial. Although there is equity for itemizers in the tax system, pluralism is narrow, excluding non-filers and non-itemizers. For charitables, total flows are likely to be reduced and their predictability decreased. For the donors, the system is inequitable and lacking in pluralism and reciprocity. For the charitables, the flows are predictable and high, but perhaps not as high as they could be.

What happens if government decides to sacrifice its legitimacy? The effects are similar to sacrifices in controllability. Small sacrifices in legitimacy result in a tax credit which, for charitables, reduces their total flows and their certainty and provides equity only to tax-itemizers. Large sacrifices in legitimacy result in a tax write-off which provides predictable and high (although not the highest) flows to charitables, and penalizes donors with inequity, narrow pluralism, and little reciprocity.

What happens if government decides to sacrifice its efficiency? If government sacrifices its efficiency by increasing administrative costs through instituting a contribution bonus, then legitimacy and controllability can be maintained at high levels. Government spending on charity through backdoor tax expenditures is eliminated and the government has greater control over its charitable subsidy, a budget expenditure. The effects on donors are beneficial as the bonus means an equitable and pluralistic system with enhanced reciprocity. Charitables maintain high flows, increased perhaps with experience, although the predictability of the total flow is reduced and the distribution among charitables altered. The contribution bonus, requiring sacrifices in administrative efficiency for government, is the most preferred public means for supporting private charity.

But is it feasible? Feasibility should not preempt desirability. Feasibility should be used to guide reason in the choice of means to the desired ends or in the choice of ends as closely related to the desirable as may be obtained under the circumstances.

V

POLITICAL FEASIBILITY

Feasibility depends on fact: who will be helped or harmed by alternative policies? The tax write-off favors the rich over the poor and moderate income groups. The tax credit takes from the rich to extend equity to moderate income but not to the poor. The bonus favors the poor and near-poor, leaves the middle income even, and disfavors the rich. Charitables would be best off under a high contribution bonus, next best off under the existing tax write-off, and worst off under a tax credit. Governmental control of charitable contributions and the legitimacy of its processes are best enhanced under a contribution bonus, next best under the tax credit, under which it could at least set the rate, and worst handled under the write-off.

The political feasibility of the four alternatives depends on future events—the strength of partisan forces, the proclivities of particular occupants of the Presidency, the worsening or lessening of inflation, the importance of tax reform and of the new congressional budget committees, and much more—that no one is in a position to predict. But is is possible, without knowing the precise probability, to lay out the main lines of future development that would affect the government's role in assisting charitable contributions. We shall, therefore, specify three main constructs in which the impetus for tax and budget reform affecting charitable contributions are least and most likely. Then, we shall try to assess which of the four proposals would do best under each of these conditions.

It may be that the impetus for reform will prove overwhelming. The growing disenchantment with the tax system may make all sorts of income deductions ("loopholes") suspect. While charitable deductions may be the least venal of all, they may still be caught up in the wake of wholesale change. The combination of unemployment and inflation may, as well, lead government to rationalize tax and spending activities by seeking clearer separation and greater control over each of them. The new congressional budget committees are institutions with a collective stake in seeing to it that a tax is a tax and an expenditure is an expenditure, and that they help determine what the difference will be. Under these circumstances, the precise nature of governmental contributions to charity would be up for grabs and the preferences of the charitables might be buried under an avalanche of reform.

There may be reform, but moderate and mixed. The existing tax system, with its progressive base overlain with numerous exceptions, may be kept but intensified. Resistance to doing away with all deductions may be so great that the attack is selective rather than comprehensive. There may be a far more progressive income tax with fewer deductions on income, or at least different ones. The more progressive the tax, to be sure, the less each higher income person actually pays toward his contribution, and the greater the disparities between the subsidies given to various income groups in the population. Incentives would be increased for the wealthier and decreased for those who would no longer pay taxes or pay very small amounts.

Perhaps the present tax system will remain essentially unchanged. The present era of economic uncertainty may make various interests fight all the harder to retain their existing privileges. It may not be so much that the existing system is considered desirable as the difficulty of finding alternatives on which people and politicians can agree that would maintain the present equilibrium. There would undoubtedly be sharp attacks on existing practices and attempts to modify particular ones, as has happened about every four to five years, for charity, but the total result would not look much different than it does now.

If we were asked to assign subjective probabilities to these three states of affairs, we would consider maintenance of the existing system as least likely, with radical reform (through a flat rate tax with elimination of deductions) as slightly more likely, and a mixed picture with emphasis on steeper tax rates, as well as selective attacks on various but not all deductions, as most likely. Objections to the existing system are so strong, we believe, that it is only a matter of time before it is subject to substantial change. The question for charitable endeavor is now to accommodate that change.

Other people's subjective assessment may differ from ours. A few may feel that radical change is just around the corner. If they turn out to be right, then charitables would be more strongly advised in their own interest to advocate an equitable mechanism, like the percentage contribution bonus, that would enable them to prosper in this new era.

An alternative assessment, which is always worth considering because it is always plausible, is that the future will bear a remarkable resemblance to the present. Tax rates, after all, have decreased rather than increased in recent years. And it is anybody's guess as to whether loopholes are larger or smaller than they used to be. So why should not the same forces that have mitigated the severity of a nominally progressive income tax operate in the future—talk of progressivism and practice of exceptionalism. But where would this projection of the present into the future leave our charitables? Safety first would suggest going along with the write-off: inequality in return for security. We think charitables would be better off *now* in trying to combine social equity with financial opportunity. If the future will be like the present, charitables interested in maximizing their resources would still be best off with the percentage contribution bonus.

By eliminating the write-off and instituting the contribution bonus, the distribution of income to charitables is shifted. On the one hand, the effect of this shift is not as substantial as a first glance might suggest. Under reasonable assumptions, philanthropic support to higher education in 1970 would be reduced by about $136 million (9 percent), from $1.53 billion to about $1.39 billion.[15] By raising the government bonus a couple of percentage points and by actively pursuing the broader base of potential contributors (about 71 million tax filers below the 40 percent tax bracket), the $136 million could be made up and higher education could be kept whole. The tired fund raiser, who has exhausted himself in running between nonexistent leads, may find this hard to believe because sufficient incentive does not now exist. With a 40 percent bonus higher education could break even by raising an additional $136 million from those contributors below the 40 percent tax bracket. Since each contribution automatically recieves a 40 percent bonus, the actual private cost to these contributors would be about $78 million ($136 x 60 percent). With a base of about 71 million potential contributors it is not unreasonable that higher education could break even or actually increase cash contributions by 10 percent. If all give, then to break even, the average private cost per potential contributor is slightly more than one dollar. Or, more realistically, if only one in a hundred gives then about $100 is the required average gift. To increase cash contributions to higher education by 10 percent, from $434 million to $477 million, one person in every hundred must give an average of slightly less than $150.

On the other hand, elite institutions, which depend on large contributions for a very large part of their income have reason to worry. Just as there are no free lunches, there is no painless way to deprive people of things they should never have had. The proper mode for governmental support of charity is, in a number of its central features, a typical policy issue. No one, given a choice today, would deliberately choose (or would publicly defend) subsidizing the rich a lot and the poor a little or not at all. But the beneficiaries have gotten used to being benefited. Our "inequity" is their "security." The problem, then, is how to move them from a position they know to be bad to one we believe to be better without threatening their future. That is why we recommend a "buy-out" of the affected interests to permit a voluntary transfer from an unjust and illegitimate method—the income tax write-off—to a just and legitimate one—the donor directed automatic percentage contribution bonus. By, in effect, insuring potential losers against loss, by giving them time to see if, in fact, they might not actually do better for themselves, we might facilitate the emergence of an integrative solution. Virtue would, at long last, become its own reward.

It may be that our ideas as to what is desirable have affected our judgment as to what is feasible. Were a method for securing governmental support of charity being designed today, however, we do not believe that anyone would even consider the tax write-off. The choice would be between a tax credit and a contribution bonus with the former being easier to administer and the latter being more equitable. If the government also had a negative income tax, so that everyone was covered by the system, tax credits would become much more desirable.

But we all live in a world we never made and must proceed from where we are rather than from where we would like to be. Even so, there appears nothing in the percentage contribution bonus that should raise unmanageable political obstacles and a great deal in the existing system that should call forth protest.

To get charitables to prefer the contribution bonus as the best of all feasible alternatives, it would be helpful to test its constitutionality and its effects on administrative costs. What would such a test look like? How can we experiment while leaving open the option to disregard the bonus should it be unconstitutional or prove to ill serve the requirements of the charitables?

VI

TESTING THE PERCENTAGE CONTRIBUTION BONUS

Any test must skillfully weave a path between the rigors of scientific inquiry and the realities of institutions. The test must be designed so that it can tell us what we need to know. But it must not upset existing institutional processes or the test is no longer a test of what we don't know but a demonstration of what we want to prove.

The most effective way for the government to test the contribution bonus is to try it on a small scale, while leaving the tax write-off untouched. An amount of anywhere from $0.5 billion to $2.0 billion could be appropriated for each of three years. This fixed sum, directed by the contributions of private individuals, would go to charitables as a bonus. Each charitable would receive part of the bonus depending upon the amount of private contributions it received. The more private contributions received, the greater the bonus going to that charity.

This experiment would allow the constitutionality of the bonus to be tested in the courts. If the bonus is deemed unconstitutional, the test could be dropped with the tax write-off remaining operative and undisturbed. If the bonus is deemed constitutional, then administrative costs for government to implement the percentage contribution bonus could be determined accurately in a real world setting. But the proposed test will certainly lead to inequities over the three-year period. Some contributors will have control over two bonuses—the tax write-off plus a percentage bonus going to their preferred charity. Other contributors (non-itemizers and non-filers) will control only the percentage bonus.

But this three-year transitional inequity is the price that must be paid to acquire a more permanent equity among charitable contributors. Any other test which attempts to apply the contribution bonus only to a particular group—either non-itemizers, non-filers, or both—suffers four severe problems. First, the results of the test for determining administrative costs would be applicable only to that group of contributors. We would remain uninformed about the administrative costs that would result from contributions by those now taking the tax write-off. Second, the cost of separating those who could direct the contribution bonus to charitables from those who could not would be prohibitive. Charitables would have to maintain separate lists of donations according to whether the contributors used the write-off or not. Third, constitutionality would be in greater jeopardy precisely because particular groups were singled out for special treatment. Fourth, and last, the validity of this experiment would be questioned on the grounds that it was not applied to everyone the way the percentage contribution bonus would be "in real life."

We think the percentage contribution bonus is good enough now to become the vehicle for governmental support of charity. However, if others disagree, they can support a small-scale, time-bound test that should better enable all of us to go from where we are to where we ought to be.

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Footnotes

1. Paul R. McDaniel. "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction," *Tax Law Review*, Vol. 27, No. 3, (Spring 1972), pp. 377-413.

2. See, for instance, Allan R. Talbot, *The Mayor's Game* (New York: Harper and Row, 1967) for vivid illustrations of brilliant gamesmen at work.

3. Harry C. Kahn, *Personal Deductions in the Federal Income Tax*. A Study by the National Bureau of Economic Research (New York, Princeton: Princeton University Press, 1960), Chapter 4, "Philanthropic Contributions," pp. 87-91.

4. McDaniel, op. cit.

5. Kahn, op. cit., Stanley S. Surrey, "Federal Income Tax Reform, The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance." *Harvard Law Review*, Vol. 84, No. 2 (December 1970), pp. 352-408; McDaniel, op. cit, Joseph A. Pechman and Benjamin A. Okner, *Individual Income Tax Erosion by Income Class*. Reprint 230 (Washington: The Brookings Institution, 1972).

6. Michael K. Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," *National Tax Journal*, Vol. 20, No. 1 (March 1967), pp. 1-19; Robert A. Schwartz, "Personal Philanthropic Contributions," *Journal of Political Economy*, VOl 78, No. 6 (November/December 1970), pp. 1264-1291; Gerard M. Brannon, *The Effect of Tax Deductibility on the Level of Charitable Contributions and Variations on the Theme.*" (Prepared for Fund for Public Policy Research, Washington, D.C., 1974), Martin Feldstein, *On the Effects of the Income Tax Treatment of Charitable Contributions: Some Preliminary Results*. December 20, 1973.

7. The total private cost for charitable contributions was $9.6 billion ($12.9B–$3.3B). The government subsidy was $3.3 billion. Therefore, the average government subsidy is 35% ($3.3B/$9.6B).

8. It is not possible to calculate the amount of this bonus since there exists no estimate of the total charitable contributions made by those not filing tax returns. Attempts to estimate the total contribution by multiplying an average contribution per non-filer by the total number of non-filers is not possible either. This is because there exists no reliable estimate of the number of individuals not filing tax returns (per conversation with Joseph Pechman, The Brookings Institution, August 1974).

9. *Tilton vs. Richardson*, 403 U.S. 672 (1971).

10. Boris I. Bittker, "Charitable Contributions: Tax Decutions or Matching Grants?" *Tax Law Review*, 28:37 (1972).

11. McDaniel, op. cit.

12. The necessity of a personal incentive to ensure that contributions are reported should not be underestimated. Even with the tax write-off, where personal gains from reporting can be realized, it is unlikely that all possible contributions are itemized. Some people just forget. Certainly the Bank of America appears to recognize this since they have introduced personal checks with a tax-deduction reminder which allows the individual to check off the appropriate deduction on the front of his check.

13. As previously indicated, the actual cost to the Treasury was $3.325 billion, but for ease in calculation we have rounded ahead to $3.4 billion. This rounding in no way affects our conclusions.

14. A special word should be said about the sliding matching grant. Table 5 provides a comparison of the sliding matching grant and the contribution bonus. On all criteria for each of the three groups, the sliding matching grant performs at the same or at a lower level than the bonus. Under the sliding matching grant, donors are worse off in terms of equity, pluralism, and reciprocity; charitables may have smaller total flows, government legitimacy is less, and its efficiency is reduced because of higher administrative costs. Since the sliding matching grant is constantly out-performed by the contribution bonus, it will be excluded from further analysis.

15. In 1970 higher education received about $1.53 billion in total contributions (Levi, Julian and Sheldon Steinbach, *Patterns of Giving to Higher Education, 1970-71*, Washington, D.C.: American Council on Education). The contribution bonus affects only about $434 million, i.e., that portion which is given by individuals in the form of cash. About 75% of the individual cash donations ($326m) came from wealthy contributors (over the 38% tax bracket) and the remaining 25% ($108m) from the middle and lower income groups. If about 60% of the flow from the wealthy represents a tax subsidy then their private costs are $130 million ($326 x 40%) and for the middle and lower income group, if about 20% is a tax subsidy, then their private costs are about $86 million ($108 x 80%). Each dollar contributed gets a 38% bonus, hence the flow of cash contributions to higher education from the wealthy is $179 million ($130 + ($130 x 38%)) and from the middle income group $119 million ($86 + ($86 x 38%)). Total flow of cash contributions is $298 million ($179 + $119). The cash reduction to higher education is about $136 million ($434 — $298) and therefore the overall reduction in revenues is about 9% ($136/$1,530 x 100%).

STUDY OF FEDERAL MATCHING GRANTS FOR CHARITABLE CONTRIBUTIONS

Paul R. McDaniel [†]

Summary

The following study examines a proposed system of direct federal matching grants for charitable contributions as a substitute for the current federal income, estate, and gift tax deductions for charitable contributions. It proceeds from the premise that private support for charitable institutions is a benefit to our society and should be encouraged by the federal government. The broad objectives of the proposed system are twofold: To institute a program that will continue and potentially increase federal financial encouragement of private giving; and to correct the inequity in the federal tax system created by the presence of the deductions for charitable contributions.

The proposed direct matching grant system is modeled on the current tax deduction system in most critical respects:[1]

1. It would offer an incentive to private charitable giving by matching with federal funds a predetermined portion of the private gift.
2. It would expend at least the same amount of federal funds for charity as is currently channeled through the tax system.
3. It would preserve the privilege of individual donors to designate the charities that receive the federal funds.
4. It would involve no more federal control over charitable institutions and the use to which the institutions put the federal monies than does the present tax deduction system.
5. It would employ much the same administrative machinery as the present system.

The proposed matching grant offers the prospect for improving the current system of providing federal funds to charities in several important respects:

1. The matching grant can be more readily modified to increase federal financial support to charitable organizations.
2. The incentive to private giving can be made more effective by correlating the amount of the federal match to the gift made by each donor to charity.
3. Federal funds can be made available for the charitable donations by all individuals, not just by those who itemize their deductions on their federal income tax returns.
4. The direct matching grant system enhances the pluralism of the present deduction system and disperses control over the federal funds to a much broader portion of the population.

Finally, significant tax reform can be achieved by eliminating, without detriment to charity, a deduction that is not properly a part of a system of taxing net income, or, in the case of the estate and gift taxes, deductions that are not properly part of a system of taxing net donative transfers.

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I

GENERAL DESCRIPTION OF MATCHING GRANT SYSTEM

Lifetime Gifts to Charity

The current charitable contribution deduction in the federal income tax would be replaced by a system of direct federal assistance for private charitable organizations through a matching grant mechanism.[2] Each donor's gift[3] would be matched by a predetermined amount from the government, the federal share to be transmitted directly to the charitable institution of the donor's choice. The size of the federal matching grant will be determined by the percent of the donor's income that was given to charity that year. The matching percentage will increase as the percent of income given to charity increases.

The following schedule is an example of a matching grant program that could be used to match all gifts to charity by living individuals:[3]

Table 1

Percent of Total Income Donated	Matching Federal Grant as Percent of Donation
Under 1%	5%
1-2	10
2-3	15
3-4	20
4-5	25
5-6	30
6-7	35
7-8	40
8-9	45
9-10	50
Over 10	55

The above schedule reflects a "progressive matching grant" approach, that is, the percentage of the federal grant increases as the donor gives a larger percentage of his or her total income to charity.

The study of direct matching grants assumes that federal spending under the matching grant program will equal the revenue gain to be derived from repeal of the charitable contributions deduction — an estimated $4.9 billion in fiscal 1975.[4]

The donation base is derived by dividing an individual's total gifts to charity by total income. Thus, as an individual increases the percentage of his total income that he gives to charity, the amount of the federal matching grant likewise increases. In general, total income includes adjusted gross income increased by items of tax preference that are presently excluded from adjusted gross income.[5]

The donor will file a schedule with his individual income tax return listing his charitable gifts and the taxpayer identification number of the charity to which the contribution was made. The donor will likewise compute his donation base as described above and then determine the federal matching percentage. The Internal Revenue Service (or other designated office in the Treasury) would credit the appropriate amounts to the accounts of the various charitable organizations. The Treasury would make annual disbursements to the charitable organizations of the amounts in their respective accounts.

Another form of direct matching grant program would employ a constant federal matching percentage that would apply to the dollar amount donated. For example, the government would provide a matching grant of 30 percent of the amount donated, regardless of the percentage of the donor's income that the gift represented. This is a "flat matching grant" approach. Under the flat matching grant approach, it is unnecessary to define total income, and it is likely that the recipient organizations, rather than the donors, would file with the Internal Revenue Service the information necessary to calculate the government grant.

Charitable organizations would qualify for receipt of matching grant funds under the same standards employed under present section 170 of the Internal Revenue Code.[6]

Appropriations for the matching grant fund should be made by Congress on a five-year or ten-year basis to permit adequate long-range planning by recipient organizations.

Arguments for and against the proposed system are discussed in Chapter II; the effects on donors and donees are considered in Chapters III and IV, respectively; Chapter V deals with administration of the program; and Chapter VII discusses constitutional issues involved in providing federal financial support to religious institutions.

Testamentary Transfers to Charity

The study also recommends that federal matching grants be provided in lieu of present estate and gift tax deductions for contributions to charity. As in the case of the matching grants for gifts made during lifetime, the direct matching grant system for testamentary transfers would match donations on a progressive basis. Thus, the percentage of the contributions matched by the Treasury would increase as the percentage of the decedent's total estate contributed to charitable institutions increased. The following table illustrates a possible matching grant schedule:

Table 2

Percent of Total Estate Donated	Matching Federal Grant as Percent of Donation
0-5%	8.3%
5-10	16.6
10-15	24.9
15-20	33.2
20-25	41.5
25-30	49.8
30-35	58.1
35-40	66.4
40-45	74.7
45-50	88.3

As in the case of the lifetime system, it would be possible to employ a flat matching grant system, for example, 30 percent of the amount bequeathed to charity rather than the progressive system in Table 2.

This study assumes that the amount expended by the federal government under the proposed matching grant system is the same as the current revenue loss sustained as a result of the estate tax deduction for charitable contributions—approximately $940 million at 1969 levels.[7]

Administrative and definitional aspects of the proposed system of direct matching grants for testamentary charitable contributions are considered in Chapter VI. The discussion of constitutional issues in Chapter VII is also applicable to the matching grants for testamentary transfers.

II

ANALYSIS OF REASONS FOR AND AGAINST CHANGE FROM TAX DEDUCTION SYSTEM TO DIRECT MATCHING GRANT SYSTEM

Reasons for Change

The Direct Matching Grant System Will Provide a More Equitable System of Expending Federal Funds for Charity

Equity from a tax viewpoint. The existence of the income tax deduction for charitable contributions is almost universally viewed as unnecessary for a proper determination of net income, the basic object of the income tax. Under a net income tax, only those expenditures which are costs of producing income are properly deductible. If a deduction, such as the charitable deduction, is allowed for expenditures that are not costs of producing income—a so-called "personal deduction"—it must be defended on the basis that it achieves some objective external to the tax system. It is not a necessary structural part of the income tax system.[8]

The allowance of such an "extraneous" deduction, however, has an important impact on tax equity. That is to say, if A and B make equal amounts of net income, but A makes a charitable contribution, A will pay less in taxes than B even though they have an identical ability to pay. Similarly, if A has net income of $100,000 and makes a charitable contribution of $50,000, he will pay the same tax as B who only makes $50,000. Yet, apart from the deduction, A has twice the ability to pay taxes as does B.

Thus, those interested in maintaining a fair income tax system see the charitable contribution deduction as violating the inegrity of the system in two critical respects: the deduction produces "horizontal inequity" because two persons with the same net incomes will pay differing amounts of tax because of the deduction; it produces "vertical inequity" because a person with a high income is able to pay the same tax as a person with a much lower income.

Proponents of the charitable contributions deduction have, from its inception in 1917, recognized that it is not a proper structural component of a tax system based on net income. The deduction has never been seen by Congress to be necessary to produce a properly defined net income. Rather, the deduction for charitable contributions has throughout its history always been justified by Congress and by its supporters as a program to provide federal aid and encouragement to private philanthropy.[9] The program has been quantified by the Office of Management and Budget,[10] the Treasury, and the staff of the Joint Committee on Internal Revenue Taxation as a "tax expenditure" program.[11] Since advocates of the deduction—both private and congressional—defend it as a federal spending program, it is appropriate to view it from the standpoint of the equity issues it raises as a spending program.

Equity from an expenditure program viewpoint. The deduction for charitable contributions is a mechanism whereby the federal government matches private donations to charity. The amount of the federal match is determined by the marginal tax bracket of the donor. For example, if a 20-percent-bracket taxpayer wishes to effect a $100 transfer to charity, the deduction system matches an $80 gift by the taxpayer with $20 of federal funds. A 50-percent-bracket taxpayer can transfer the same $100 to charity by making a $50 gift since the federal government will match his gifts with another $50. For a 70-percent-bracket taxpayer, the deduction system matches a $30 gift by the taxpayer with $70 of federal funds.

Put somewhat differently, the federal government matches the 20-percent-bracket individual on a 1 to 4 ratio, the 50-percent-bracket taxpayer on a 1 for 1 ratio, and the 70-percent-bracket donor on a 2.3 for 1 basis.

Table 3 illustrates the matching grant schedule under the present deduction system for a single person at various selected taxable income levels who wishes to transfer $100 to charity.

Under the deduction system, the taxpayer-donor writes only one check to charity. But, in fact, that check represents two separate contributions: one which is the donor's own private gift and the other, the government's matching contribution. The donor is in effect designated as the government's paying agent for its share. The government then settles up with the donor when the income tax return is filed on April 15.[12]

The financial information supplied to Congress by Vice-President Rockefeller provides a dramatic example of how the tax deduction matching grant system operates.[13] In 1973 Mr. Rockefeller donated $1,656,982 to various charitable organizations. From a tax standpoint, the deduction reduced Mr.

Table 3

Taxable Income	Total Gift	Taxpayer's Contribution	Government Matching Grant
$ 0	$100	$100	$ 0
1,000	100	85	15
5,000	100	79	21
10,000	100	75	25
25,000	100	60	40
50,000	100	40	60
100,000	100	31	69
200,000	100	30	70

Rockefeller's federal income taxes by some $1,159,887. Instead of requiring that this amount be paid to the Treasury, the federal government in effect agreed to let it be paid over to the charity of Mr. Rockefeller's choice if he would match it with $497,095 of his own funds. This net out-of-pocket cost apparently constituted less than 10 percent of Mr. Rockefeller's economic income in 1973. Solely because of his income bracket, Mr. Rockefeller's gifts triggered a $2.33 federal match for each $1 of his own funds given to charity. But a $10,000 wage earner, who gave the same percentage of his income to charity, would have received no federal matching grant if he claimed the standard deduction.

Whether one regards as equitable the spending program described above depends, to some extent, on the purpose that is seen to be served by the program. Two broad purposes are generally advanced. One, which may be termed a "philosophical" perspective, regards the deduction as a "reward" system; the other, roughly denominated the "scientific" perspective, perceives the deduction as creating an economic bias for a particular form of private consumption.

The philosophical concept of rewarding sacrifice for the public good is premised on the view that all members of society are subject to certain minimal obligations and duties. Compliance with these minimal duties is demanded of everyone; failure to comply is regarded as a wrong and a matter for censure.[14] Above and beyond these obligations and duties, however, is the area of moral ideals. Compliance with these moral ideals is valued behavior, not expected as a matter of course, and is seen as achievement worthy of praise and reward. Charitable giving is usually placed in this latter category of ideal behavior and, hence, appropriate of a reward. The donor has given up the opportunity to consume certain material goods for his own pleasure and instead has given a certain percent of his income or wealth for the common good. The spending program effected through the charitable deduction should, under this view, be tested for its equitable operation as a reward system.

On the other hand, most economists and social psychologists take the scientific view that charitable contributions are not simply individual sacrifices for the public good, but are actually consumption spending. This view is based on the economic theory that the consumer is a utility (or satisfaction) maximizer.[15] He allocates his limited resources in such a way that each dollar purchases the maximum amount of satisfaction available to him. The "sacrifice" of the philosophical perspective is thus shifted to utility provision. When the consumer makes a decision to give to charity he first looks at all possible forms of consumption and determines which is preferred. Then and only then does he consume. If the decision is to make a charitable gift, the individual is seen as purchasing status, the perpetuation of his social values or, on a less mercenary level, the satisfaction resulting from doing a "good deed." Under this view, the expenditure program effected through the charitable deduction creates an economic bias in favor of a certain kind of consumption—charitable donations—over other forms of consumption available to consumers. And one can inquire as to whether the deduction operates equitably as an incentive system to induce this form of consumption. (See Appendix A for a more extended discussion of the conceptual problems involved in analyzing the deduction as a "reward" or as a bias for a particular type of consumption.)

These two theoretical perspectives expose a fundamental tension that exists in both the present deduction system and the direct matching grant program. The philosophical view looks to the degree of sacrifice and tends to focus on providing rewards commensurate with effort, that is, the "equity" aspects of the system. The scientific view points to the incentive effect of a system, whether it is seen as "fair" or not. The goals of equity and incentive cannot be completely achieved in any system for encouraging charitable giving. What is required is an appropriate balance between the two desirable objectives.

Whether the present charitable contributions deduction is viewed as an incentive or as a reward for charitable giving, it has an operational effect for at most 40 percent of those who file income tax returns.[16] Since the deduction may only be claimed by those who itemize their personal deductions, it is obvious that no reward and no incentive is offered to the 60 percent of the taxpayers who claim the general standard deduction or the low-income allowance, nor for those who file non-taxable returns. Indeed, the 40 percent figure overstates the number of individuals who can qualify for the incentive-reward. Section 6012(a)(1) of the Code exempts from the return filing requirement those whose incomes fall below the poverty level. An estimated 15 million individuals are excused from filing returns because of this provision.[17] If these individuals are taken into account, then the incentive-reward is operative for only 34 percent of those who are potential contributors to charitable organizations.

If the federal government is to offer a reward or an incentive to individuals to make gifts to charitable institutions, it is difficult to justify on equitable grounds a system that operates only for 34 percent of the potential contributors. In other words, why should a $12,000 wage earner who itemizes his deductions be given a reward for his contribution to charity, but no reward is provided for a $12,000-per-year individual who claims the standard deduction but gives the same amount to charity? At the minimum, equity would seem to require that those who give similar amounts to charity should receive a similar reward from any federal program designed to encourage charitable giving. And why should we forego offering to the vast majority of our citizens any incentive to give to charity?

But even this concept of equity appears too limited. The present system, since the reward-incentive is a function of the income tax bracket of the donor, provides a relatively greater reward or incentive to the high-bracket individual who gives the same percentage of his income to charity as does a low-bracket contributor. Thus, an individual making $200,000 a year receives a 70 percent matching grant if he gives 10 percent of his income to charity. Yet the $12,000-per-year wage earner will receive only a 25 percent matching grant from the federal government even though he also gives 10 percent of his income to charity. Thus the wealthy individual is rewarded to a greater extent for making precisely the same relative contribution to charity as the lower income individual. Indeed, one may question whether a 10 percent contribution by a $200,000-per-year income individual even constitutes relatively the same effort or sacrifice for charity as does a 10 percent contribution by a $12,000-per-year wage earner. But even on an absolute basis, the inequity of the present reward program is obvious. And we can well ask, from the incentive standpoint, why it takes three times the federal incentive to induce the $200,000-per-year individual to make the same relative contribution to charity as his $12,000-per-year counterpart.

The equity problem may be viewed another way. Since the amount of the federal funds that may be controlled by a particular contributor increases with his income tax bracket, it is obvious that the wealthy are given control over the great bulk of the federal funds expended through the present deduction system. In calendar year 1972, an estimated $3.4 billion in federal funds was expended via the charitable contribution deduction. Of this amount $2.6 billion was expended by those with adjusted gross incomes in excess of $15,000 per year.[18] In 1972, approximately 15 percent of the returns filed showed adjusted gross incomes in excess of $15,000 per year.[19] Yet these 15 percent were given the power to control 78 percent of the federal funds made available for private philanthropy through the charitable contributions deduction. Even more startling, the .5 percent of the taxpayers with incomes in excess of $50,000 a year were permitted in 1972 to control $1.2 billion of the federal funds made available by the charitable contributions deduction. In other words, 37 percent of the federal funds were controlled by the wealthiest one half of one percent of the people in the country.[20]

A rough picture of the estimated distribution of control over the federal funds delivered through the charitable deduction system in 1972 is set forth in Table 4.

Table 4

Percent of Tax Returns	Classification	Percent of Federal Funds Controlled
59%	Standard deduction, low-income allowance, and non-taxables.	0%
28	Itemizers below $15,000 AGI.	23
12.3	Itemizers between $15,000-50,000 AGI.	40
0.5	Itemizers above $50,000 AGI.	37
100.0		100

Numbers may not add due to rounding.

Source: Derived from Statistics of Income (1971), pp. 78, 79, 82 and Estimates of Federal Tax Expenditures, Staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation (Committee Print, 1973), pp. 9, 10.

To further illustrate the disproportionate power that the present deduction system gives to the wealthy in the disposition of federal funds, it should be noted that those with adjusted gross incomes in excess of $50,000 in 1970 accounted for only 14 percent of the total itemized contributions to charity in that year.[21] If contributions to charity by non-itemizers are taken into account, then this highest income group contributed less than 10 percent of the total funds that were donated to charity in 1970,[22] yet they were entitled to control approximately 37 percent of the federal funds made available through the deduction system. By contrast, those claiming the standard deduction also gave an estimated 20 percent ($3.8 billion) of the total funds going to charity in 1970,[23] yet they were entitled to control not one dollar of the federal funds.

It is interesting to note that in another study for the Commission, two political scientists (who expressly disavow any tax expertise) reached the same conclusions regarding the inequity of the present deduction system. Thus, Professors Wildavsky and Good of the University of California concluded that not only is the present system of encouraging charity inequitable, but that the continued existence of this inequity has adverse spill-over effects. As political scientists, they perceive that the failure to correct the inequities described above diminishes public confidence in the fairness of the tax system and thence erodes the very legitimacy of our political institutions. They conclude: "Surely no one today would deliberately set out to create a method of financing charitable contributions by the government that would add, say, 70 percent to the rich man's contribution, 14 percent to the poor man's, and nothing at all to the poorest . . . . Despite ingenious rationalizations, these inequities are real. . . ."[24]

Thus, whether one thinks that an equitable reward system should be based on an absolute or on a relative measure of contributions, the present federal expenditure program for private charitable organizations effected through the charitable contributions deduction is difficult to defend on equity grounds.

Equity under the direct matching grant system. A direct matching grant system can mitigate substantially the inequities that result from utilization of the tax-deduction mechanism to provide federal funds to charity. In summary form, the direct matching grant system improves equity in the following respects:

1. All contributors, not just those who itemize their deductions, will be eligible to control the federal direct matching grant funds.

2. Federal matching grants will be made available on the same basis for every donor, regardless of the donor's income tax bracket.

3. The extreme disparity between the amount of federal funds controlled by the wealthy and the amount controlled by lower-income individuals is substantially mitigated (and can be eliminated, if so desired).

4. The charitable contributions deduction would be repealed, thus removing one source of inequity in the income tax system.

The first and the most obvious advance in equity is that all contributors to charitable organizations become entitled to have their contributions matched by federal funds regardless of whether they itemize their charitable contributions for income tax purposes or claim the general standard deduction or low-income allowance, or indeed if they incur no income tax liability at all. It is the act of making a charitable contribution that will trigger the federal matching grant under the proposed system, not the act of itemizing personal deductions on an income tax return. This feature of the direct matching grant program insures that all citizens in the United States—not just the upper-income segments of our society—have the opportunity to exercise control over the federal funds made available for private charity if they so desire.

Use of the matching grant formula also insures that each individual's contribution will be matched on the same basis regardless of his income tax bracket. Thus, on a progressive matching grant schedule, a person in the 70 percent bracket who contributes 5 percent of his income to charity will trigger the same percentage federal matching grant as does a 14-percent-bracket taxpayer who contributes 5 percent of his income to charity. Or, on a flat percentage matching grant schedule, the 14-percent-bracket donor who gives $300 to charity would generate the same dollar federal matching grant as the 70 percent donor who gives $300. The direct matching grant program thus focuses on the charitable donation made by each individual as the appropriate basis for determining the percentage federal matching grant, rather than the income tax bracket as under the present system.

The proposed federal matching grant system also produces a much more equitable allocation of power over federal funds than does the present charitable contributions deduction. As noted above the one half of one percent of upper-income individuals with adjusted gross incomes in excess of $50,000 control approximately 37 percent of the federal funds expended through the charitable contributions deduction. By contrast, had the progressive direct grant system been in effect in 1970, the wealthiest one half of one percent would have controlled only $218 million out of the $3.5 billion expended through the deduction in that year.[25] This constitutes control over 6.2 percent of the funds for this group as compared with the 37 percent under the deduction system. Whether the direct matching grant system should go still further in reducing the control of the very wealthy over even this large a portion of the federal funds is considered on page 2446.

The proposed matching grant system is advanced on the basis that it is a more equitable system of dispersing federal funds for charity than is the present charitable contributions deduction. As with any system for which an "equity" claim is made, certain value-laden assumptions are involved in the system that should be identified and examined. How one evaluates these assumptions will determine whether one prefers the progressive matching grant system or the flat matching grant system. Either matching technique represents an improvement in equity grounds over the present deduction system. Two fundamental questions should be considered at this point: (1) Should income be used as the base against which contributions will be measured for purposes of determining the amount of the federal matching grant? (2) Should the amount of the federal matching grant be determined by "relative effort" (that is, ratio of contributions to total income) instead of merely on the basis of absolute dollars contributed?

Income as the donation base. It may be contended that utilization of income as the donation base in the progressive direct matching grant program creates its own equity problems. While we are tied to income as the measuring rod if the federal financial aid is to be effected through the income tax system, could we not shift to a broader base if we are going to move outside the tax system? One possibility that suggests itself is the total "wealth" of a contributor. The use of wealth, it could be argued, is more equitable than the use of income since tying the matching grant system to income means that persons with accumulated wealth can trigger the matching grant by gifts out of that accumulated wealth, while retaining their current income for other consumption purposes. On the other hand, wage earners would, by and large, have to use current income to trigger the grant.

There are several reasons for rejecting wealth as the base for the direct matching grant. One, the concept of wealth is, if anything, more difficult for economists to define than is the concept of income.[26] It does not seem sensible to discard the experience of almost 60 years in dealing with the term income under the income tax (and a variety of federal welfare programs) to embark on a new definitional search simply to effect a matching grant system.

If one is uneasy about the possibility that wealthy persons can use accumulated wealth to trigger matching grants under a system that is geared to income, it is not clear that the concern really arises out of the matching grant system itself. Instead, one's unease may be caused by the failure of the income tax system to include all forms of increases in net worth, including gifts and bequests, in income. Under an ideal concept of income, accumulated wealth was at one time income (in the economic sense of the term).[27] It represents deferred consumption and the decision to make a charitable contribution out of accumulated wealth represents a decision to end that deferral. If this is the case, then the use of accumulated wealth is simply the use of deferred income to trigger the matching grant system. Hence the problem under a progressive matching grant system is merely one of "bunching," that is, by deferring charitable contributions a donor can trigger a higher matching grant than if he made a gift in each year. But this "bunching" problem can be solved in the context of the matching grant system itself. (See Chapter V, page 2475.) While the current income tax base certainly has flaws and defects—must notably, in our context, the failure to tax gifts and bequests—it would be inappropriate to undertake to correct changes in the income tax base *solely* in order to improve the operation of the matching grant system. On the other hand, it is inappropriate to criticize the use of income as the base for the matching grant system because of problems that are fundamental to the income tax system.[28]

In addition, one's concern about the problem of utilization of accumulated wealth to trigger the matching grant program may be alleviated to some extent if income is a good proxy for wealth. Here the somewhat sketchy data reveal some relationship between wealth and income, but that relationship is far from exact. According to a study based on 1962 data, when consumer units were ranked by income, the top 1 percent owned 25 percent of the wealth but received only 8 percent of the income. The top 20 percent of families received 41.7 percent of personal income but owned 77 percent of personal wealth.[29] One can conclude from this data that wealth is related to income to the extent that large wealth holdings tend to be associated with high income. However, it is also obvious that income distribution in the United States is much more equal than is wealth distribution. Thus, it is fair to conclude that high-income families will be able to use accumulated wealth in order to trigger matching federal grants to a relatively greater extent than lower-income families. But one again is led to the conclusion that this is a problem that must be resolved within the federal tax system itself and cannot really be resolved in a program whose limited purpose is to provide federal financial assistance to charitable organizations. And, as noted above, if one desires to reduce as an absolute matter the amount of federal funds controlled by the wealthy, the direct matching grant system can be readily modified to achieve this result, as discussed on page 2446.

Relative effort versus absolute dollars. The use of relative effort in a matching grant system does create problems. The use of income as the base requires that we deal with all of the income definitional problems that are inherent in the income tax system; this problem is discussed on page 2472. Use of a progressive matching grant schedule requires that we deal with "notch" problems and averaging problems; these are discussed on pages 2447 and 2475.

Many definitional and administrative problems could be avoided by establishing a flat matching grant based on the dollars contributed. Thus the matching grant system would simply provide that each dollar contributed to charity would be matched by 30 percent of the dollars donated. The flat matching grant system avoids all definitional problems and administrative problems inherent in utilizing a progressive matching grant schedule tied to income.[30]

At this point, the question for the policy maker is whether a flat matching grant system or a system based on relative effort is more equitable. The following discussion seeks to identify those aspects in each system that bear on the equity issues.

The concept of equity that is involved in a flat matching grant is that everybody's dollar—rich and poor alike—is treated the same. This concept of equity undergirds the use of tax credits, and certainly represents a decided improvement in equity over the present deduction system. It must be recognized, however, that under a flat matching grant system, the wealthy individual can control the same federal funds as the lower-income individual with much less loss of alternative consumption power. Thus, if a person making $100,000 per year gives $1,000 to charity he will, under a 30 percent flat matching grant system, for example, trigger a $300 federal matching grant. A $10,000-per-year individual who gave $1,000 would also trigger a $300 matching grant. Under a progressive matching grant schedule geared to relative effort, the $100,000-per-year individual, since he has given only 1 percent of his income to charity, would be entitled to only a 5 percent federal matching grant ($50). But the $10,000-per-year wage earner who gave the same amount would trigger a $100 federal grant. Only by increasing his effort on behalf of charity threefold can the $100,000-per-year individual trigger the same absolute federal funds under the progressive matching grant system as would be the case under a 30 percent flat matching grant system; and he would have to increase his gift to $10,000 to qualify for the same percentage matching grant as the $10,000-per-year individual who gives $1,000. Thus, a progressive matching grant system tends to reflect the ideals of a progressive income tax structure.

The progressive matching grant system also assumes that the person who had made the greater effort for the common good should be given the greatest reward; and correspondingly, we ought to encourage such effort on the behalf of the common good by providing incentives for greater relative effort. An example may make this point. Suppose a person is drowning in a calm lake. The owner of a passing boat stops and pulls the drowning person out of the water. Now suppose a person is drowning in a stormy ocean. At great risk to his person and his property, the owner of a passing boat stops and rescues the drowning individual. In each case the contribution to society is the same, that is, a single life has been saved. But, it can be argued that the second boat owner is the more praiseworthy since he has made that gift at a greater personal sacrifice. Similarly, the individual who donates 10 percent of his income for the public good, thereby foregoing 10 percent of his total consumption choices, is seen to be more praiseworthy and deserving of greater reward than is the person who gives away only 1 percent of his consumption choices, even though the dollar amounts given to charity by each are the same.

Indeed, some would argue that the progressive matching grant system does not go far enough in recognizing the relative sacrifice of lower-income as opposed to wealthy individuals. Thus it could be argued that the poor should receive larger incentive-rewards than the wealthy for giving the same percent of their income to charity. This argument is based on the fact that the rich have so much more left after making an equal percentage contribution to charity that it is easier, and therefore less praiseworthy, for them to give the same percentage of their income to charity. The difficulty is that the economic case for this argument is less than clear;[31] economists do not all agree that it is easier for a rich individual than it is for a poor person to give away the same percent of income. Indeed as a psychological matter, it may be more difficult for a person with wealth to give it away than it is for a person who has never had the wealth to live without it. And, as discussed on page 2446, requiring the wealthy to give a higher percentage of income to charity than lower-income donors would have an impact on the incentive effect of the matching grant system. (Some of the considerations involved in the reward-incentive dichotomy are discussed in greater detail in Appendix A.)

On the equity issues, the above analysis warrants the following conclusions:

1. A direct matching grant system—whether of the progressive or flat percentage type—is more equitable than the present deduction system.
2. The choice between the progressive and flat matching grant systems is determined by whether one believes that relative effort or absolute giving more appropriately reflects the value judgments of our society; reasonable people can reach differing conclusions.
3. If a progressive matching system is selected, the use of "income" as the base against which to measure relative effort is both appropriate and defensible.

The Direct Matching Grant System Will Enhance Pluralism and the Dispersion of Power Over Federal Funds

The argument frequently advanced by proponents of the charitable contribution deduction is that it promotes pluralism and effects a dispersion of power.[32] Pluralism under the present deduction system is achieved by giving to certain individuals the right to designate how the federal funds for charity will be spent. The choices of these individuals determine the uses to which the federal funds will be put, free of government directive or control.

In fact, of course, the present deduction system "disperses" power only in a peculiar sense of the term. It may more accurately be viewed as the vehicle by which power is further concentrated in the hands of the wealthy. The power is transferred from the federal government to the already very powerful wealthy. Thus, as noted above, Vice-President Rockefeller in 1973 was given the power to control $1.1 million of federal funds for the charities funded by him. The "dispersion" of power effected by the charitable contribution deduction has only served to enhance the concentration of power in the hands of a few wealthy families in the United States.

The argument for pluralism, however, has merit and is one that must be taken seriously by any advocate of an alternative system. The argument represents a viewpoint shared by many Americans. We sense that multiple approaches to problems are desirable, that individuals and organizations outside government can provide programs and ideas that might have difficulty surfacing in the government, and that giving the individual the power to designate the objects of his charitable interests is conducive to achieving these ends.

But, as seen above, the present system confines this kind of pluralism to some 34 percent of the adult population. And this fact raises difficult questions for defenders of the deduction system. If the present degree of pluralism is good, would our society not be greatly enhanced if the pluralism could be extended to 100 percent of charitable contributors? Or, if it is good to disperse power over $4.0 billion of federal funds, why do only 34 percent of our citizens get to control the distribution of funds contributed by all taxpayers?

Proponents of the pluralism argument must face the fact that the charitable contribution deduction mechanism achieves relatively little pluralism. And that pluralism is operative in the most part only for the upper-income individuals in the country. If private control of federal funds provided to charity is good, then it seems plain that the pluralistic ideal is better achieved when a $5,000-a-year wage earner can be the designating agent for the part of the federal funds just as is the $250,000-a-year individual.

The force of the above objections appears to be gaining acceptance by those concerned with encouraging a private individual/government partnership as the best means of aiding private philanthropy. For example, John D. Rockefeller, III, recently proposed that the deduction be extended to all taxpayers, not just those who itemize their other deductions. His suggestion was premised on the belief that "one of the things that needs doing is to encourage the small giver, because the strength of our pluralistic society is largely based on individual initiative at all levels."[33]

In terms of pluralism, the benefits of the matching grant system are obvious. The direct grant system would expand the potential paying agents for the federal system from 30 percent to 100 percent of the population, whether taxpaying or not.

The control aspect of the pluralism argument is also satisfied. Each donor will be entitled to direct the federal matching grant triggered by his contribution to the charity of his choice. Thus, the fund-raising activities of the charities will still be directed to the individual donor, not to the government.

It is apparent that acceptance of the pluralism ideal may involve a distribution of federal funds for charity in a fashion that is different from the present pattern. Since upper-income individuals control most of the federal funds under the deduction system, charities favored by such persons presently receive the bulk of the federal financial assistance. The matching grant system will shift—either relatively or absolutely—some of this designation power to lower-income donors and hence benefit the charities supported by them. Estimates of the magnitude of this shift are examined in detail in Chapter IV.

The primary concern over this shift is voiced by representatives of colleges and universities, museums, and symphonies which constitute the favored charities of the wealthy. They would probably lose some of their present federal funds to community chests and churches, which are the charities most heavily supported by lower-income donors.[34]

This shift is one that simply must be accepted if we are also to accept the logical consequences of the pluralism argument. It does not seem possible to defend a system by arguing for pluralism, but then carefully define the pluralistic parameters to include only those donors who will direct funds to a particular class of charities. As is discussed in Chapter IV, various strategies are available to prevent a reduction in overall receipts by higher education, museums, and symphonies. But these strategies must be consistent with the goal of permitting *all* donors to charity—not just upper-income donors—to direct federal funds to the charity of their choice.

The Direct Matching Grant System is More Effectively Targeted to Charitable Giving than the Income Tax Deduction

The direct matching grant system will be a more effective incentive to the act of charitable giving than is the present deduction. The increased effectiveness results from two factors:

1. The incentive is related only to the act of charitable giving.
2. The progressive matching grant rates offer a strong incentive to increase charitable giving.

One curiosity of the present deduction system is that control over the federal funds is determined more by other aspects of a donor's economic and social life than by the act of charitable giving. Thus, in 1970, only 2 percent of the 33.6 million returns with itemized charitable contributions reflected contributions in excess of the standard deduction.[35] In other words, if the charitable contribution deduction had been the only itemized personal deduction allowed in 1970, 98 percent of those claiming the charitable contribution deduction would have shifted to the standard deduction and hence would have been outside the present matching grant system.

These data mean that the present incentive-reward is offered not just to those who make charitable contributions. It is really offered to those who incur other expenses that give rise to itemized deductions—homeowners with deductions for interest and taxes, those with large medical expenses, two-worker families with child-care expenses, consumers who incur interest for installment purchases, divorced spouses who pay alimony, and the like.

The direct matching grant system—whether progressive or flat rate—focuses solely on the act of making a charitable donation. Under the proposed system it is irrelevant what other economic or social activities the donor does or does not engage in. If he performs the single act for which we are interested in providing an incentive—charitable giving—the federal matching grant funds are automatically made available.

The adoption of a progressive matching grant schedule may provide an additional incentive by providing a larger matching grant as a donor gives a larger percentage of his income to charity. Under the present system, a donor in the 25 percent bracket is offered a 25 percent matching grant if he gives 1 percent of his income to charity. But, he is offered the same flat rate to give 50 percent of his income to charity. While a larger dollar amount of federal funds can be controlled by making the larger gift, it is obvious that a more potent incentive to increase the gift would be effected if the percentage of the gift matched also increased.

Indeed the present deduction system may operate for some donors in precisely the reverse fashion. If increasing the amount of the charitable contribution caused the donor's marginal bracket to fall from 25 percent to 22 percent, the incentive to give has actually decreased as the percent of total income given to charity has increased. Such an effect is, of course, directly the opposite of the manner in which an effective incentive system should operate.

The matching grant system is not, of course, a perfect incentive system. Problems are created in a progressive schedule by the "Notch" aspect of the progressive scale, and under both flat and progressive matching schedules, there is a ceiling on the matching grant schedule. These aspects are considered on pages 2447 and 2448, respectively. But these problems do not seem particularly troublesome. And, in any event, the proposed system represents a decidedly more effective incentive to increased charitable giving than does the present deduction mechanism.

The Direct Matching Grant System Provides a More Rational Framework Within Which to Determine the Amount of Federal Aid to Charity

A direct matching grant system offers two important advantages—to charities and government alike—over the present deduction system insofar as rational expenditure of federal funds is concerned.

1. The amount of federal funds available for charity will be specifically earmarked so that it will not be affected by completely unrelated congressional actions.

2. **The possibility of increasing the amount of federal funds for charity is greatly enhanced.**

For the years 1969-1973, the federal government expended $3 to $4 billion annually as its share of the combined federal-private matching grant system effected through the charitable contributions deduction.[36] But because the federal share is made available through the deduction, numerous other actions by Congress, totally unrelated to the program for charitable organizations, have affected the amount of the federal contribution. Seemingly charitable organizations have been as uninformed of the impact of these actions on their funding as has Congress itself. Such a situation is unhealthy, both for charities, which rely on these funds, and for Congress, which is responsible to the taxpaying public for intelligent expenditure of the public's funds.

Several examples can demonstrate the point. While Congress in 1969 took various actions directly affecting the charitable deduction,[37] including increasing the limitation on the charitable contribution deduction from 30 to 50 percent of adjusted gross income (AGI), it also passed several other measures that affected the amount of federal funds given to charity. The standard deduction was increased over four years from 10 percent of AGI (or $1,000) to 15 percent of AGI (or $2,000). This action had the effect of shifting an estimated 8.7 million taxpayers from itemizing their deductions to claiming the standard deduction.[38] Obviously, the amount of federal funds for charity was at the same time reduced, although the increase in the standard deduction certainly did not have that result as its objective. Similarly, the introduction of the 50 percent maximum marginal rate on earned income[39] cut the federal share from 70 to 50 percent for high-bracket donors who made contributions out of earned income. If one accepts Professor Feldstein's analysis of the efficiency of the deduction (discussed on page 2440), charitable organizations suffered an absolute financial loss by this congressional action. On the other hand, when Congress in 1969 increased the capital-gains rates it increased the federal matching grant for those who made contributions in the form of appreciated property (from a potential maximum of 95 percent to 105 percent).[40]

In 1971, Congress acted to accelerate the increase in the standard deduction.[41] This move speeded up the reductions in the federal share for charity already effected by the 1969 changes.

The 1974 tax revision efforts by the House Ways and Means Committee reveal that the same process is continuing. Charities focused their efforts on eliminating from the proposed new minimum tax the gain element in appreciated property donated to charity. Obviously, this action—without any corresponding effort to direct the increased tax revenues to charity—would reduce the federal financial program for charity. But charities apparently did not recognize that other changes proposed by the Ways and Means Committee would have much more serious effects on the level of their federal funding via the deduction. Thus the Ways and Means Committee decision to permit certain amounts of unearned income to qualify for the 50 percent maximum marginal rate will, if enacted, reduce the federal contribution to charity. So too will the 1975 increase in the general standard deduction. And, most dramatically, the Ways and Means Committee proposes to cut back substantially the federal share made available for contributions of appreciated property. The proposed new rules for long term capital gains mean that for the 70-percent-bracket donor, the federal matching share has been reduced from 105 percent to as low as 91 percent.[42]

So far as one can tell, neither representatives of charitable institutions nor members of the committee gave any consideration to the impact that the proposed changes would have on charitable contributions. And indeed the committee at least can hardly be faulted for this. It was, after all, focusing on economic and social issues quite different from private philanthropy when it was considering the standard deduction, capital-gains rates, and the maximum tax.

Research has not disclosed any study that has quantified the net effect on charities of all the tax actions taken by Congress since 1969 that affected the amount of federal funds made available through the tax deduction. But it is quite possible that charity will be a net loser if the 1974 Ways and Means Committee proposals are enacted, even if charitable organizations succeed in keeping appreciated property donated to charity out of the minimum tax. And yet there is no reason for charity to lose as a result of any of these actions. They involve issues totally separate from federal support for charity. Charity automatically loses funds only because it presently derives those funds from the tax-deduction mechanism.

As the above examples illustrate, the level of federal funding for charity is now affected by tax actions that have nothing to do with support of charitable organizations. So unknowing an approach to a program that is of major significance to charitable organizations and to the whole country seems indefensible.

These problems are eliminated in a direct matching grant system. A separate five- to ten-year appropriation would be made for charity which would automatically increase in amount as charitable giving increased. No action taken by Congress with respect to the tax system—or any other federal program—would affect the funding for the charitable program. Of course, Congress could reduce the level of funding for the program. But it could do so only by direct consideration of the charitable program as such. It could not effect a reduction in funds for charity by reducing tax rates, as it can and does under the present system. At the least, charities would gain by knowing when to present their case when adverse action is contemplated by Congress, a situation that does not prevail at the present time. And that case could be presented strictly in the context of federal aid to charity rather than, for example, federal aid to charity versus the need for increased tax incentives for saving, as is true now. (The question of whether direct congressional consideration of the federal program for charity is desirable—or avoidable—is considered on page 2449.)

The above discussion also indicates that a shift from the tax deduction to the direct matching grant system will free charity from the limitations that are inherent in the tax mechanism. One of these constraints is that charity is forced to defend provisions that are untenable from a tax standpoint, for example, the deduction for the full fair market value of appreciated property donated to charity with the gain going permanently untaxed.

But another limitation is that charitable organizations appear precluded, as a practical matter, from ever securing a meaningful increase in the level of federal funding so long as they are tied to the tax system. This conclusion stems from the fact that the amount of federal funds delivered through the deduction mechanism is directly a function of rates. And the current tax trends are all unfavorable to charity in this regard. Thus the trend at the upper end of the rate schedule seems to be toward a 50 percent top bracket. This, of course, reduces federal funds for charity and, if the deduction has any incentive effect, the overall amounts that charitable organizations receive. Similarly, the rates for capital gains may be reduced, which would have the double effect of (1) reducing the incentive to give for donors whose income is composed largely of capital gains (primarily over-$100,000-AGI individuals), and (2) reducing the incentive to give appreciated property.

At the lower end of the income scale, the tax trend is likewise adverse to charity. Here it is plain that increases in the standard deduction represent the preferred technique for Congress to provide tax reduction to low- and middle-income taxpayers. But each increase in the standard deduction reduces federal funds for charity since no longer will the federal program be operative for those who no longer itemize their personal deductions.

The above analysis suggests that charities, if the tax deduction system is continued, must seek an increase in the level of federal funding by urging an increase in tax rates—whether by raising marginal rates, reducing the standard deduction, or imposing higher rates of tax on capital gains. But aside from the political fallout from urging such actions, it is obvious that charity cannot hope successfully to urge steps that have widespread and complex economic results solely to increase federal funds going to charity.

One other tax change could be urged by charities to increase federal funds made available via the deduction. They could seek to increase the present 50 percent limit on charitable contributions. But here again, charitable organizations would be swimming against the tide of tax developments. The elimination in 1969 of the 100 percent charitable contribution deduction was a clear signal that, as a general rule, the deduction cannot be used to eliminate more than one half of an individual's income from the tax base. This same principle underlies the revision of the minimum tax proposed by the Ways and Means Committee in 1974.[43] Reliance on securing an increase in the present 50 percent limit as a means of increasing federal funds to charity thus seems ill-advised.

By contrast, adoption of the proposed federal matching grant system frees charitable organizations from the above limitations. An increase in the levels of federal funding can be effected simply by raising the federal matching percentages.[44] And arguments for such increases can be directed to Congress solely on the basis of the merits of the matching grant program unencumbered by the totally extraneous considerations that are involved with increasing the federal share under the present tax deduction program. Table 14, page 2465 illustrates the effects of a direct matching grant system in which the present level of federal funding has been increased by 50 percent.

In sum, it appears that charities and government alike would benefit from open and knowing consideration of the level of federal funding for a matching grant program for charity. The proposed direct matching grant program insures that result, whereas the present deduction system largely precludes it.

The Direct Matching Grant System Will Provide an Efficient Incentive to Donors to Give a Larger Percent of Their Income to Charity

The present deduction for charitable contributions operates as an incentive in a two-fold manner: (1) the government will automatically match the gifts of the donor to charity (the matching percentage to be determined by the donor's tax bracket); and (2) the donor can designate the recipient of the federal funds and can control the uses to which those funds will be put if he so desires.

A critical question must be asked with respect to the incentive aspects of both the federal matching grant system effected through the charitable contributions deduction and the proposed direct matching grant system: Is the incentive offered through the present deduction system an efficient one, and can the proposed direct matching grant system equal or improve the efficiency of that incentive?

The following materials consider first the analyses that have been developed by economists as they have sought to test the efficiency of the present deduction as an incentive system. Then the results of survey data and of matching grant programs that are presently in effect will be reviewed. Finally, the implications of the economic and survey data for the proposed direct matching grant system will be considered.

General comments on efficiency as a factor in evaluating the deduction and the matching grant system. Before examining the economic and survey data on the efficiency of the present income tax deduction it is appropriate to bear in mind points that have already been made with respect to the present deduction system:

1. The deduction is inequitable from both a tax standpoint and an expenditure viewpoint.
2. The deduction limits the power to control federal funds for charity to the upper-income segment of our society.
3. The deduction is not effectively targeted to provide the maximum incentive for charitable giving.
4. The deduction mechanism constitutes an irrational system of appropriating federal funds for charitable organizations.

It is against this background that we test the efficiency of the charitable deduction mechanism. Economists, as we shall see, are not in agreement as to the efficiency of the present system. But even if one accepts the most favorable view on the deduction's efficiency, the question must be asked whether the price we pay for that efficiency in the above respects is too great. If the proposed matching grant system can equal or exceed the deduction system in efficiency, while at the same time eliminating—or substantially mitigating—the defects of the present system, then the case for a shift to that system is compelling. Even if the proposed matching grant appears somewhat less efficient, we must still ask whether we are prepared to trade off some efficiency for greater equality, pluralism, effectiveness, and rationality.

Economists' views of the efficiency of the income tax deduction. The incentive to charitable giving effected by the present charitable contributions deduction occurs by virtue of the reduction in the price of giving equal to the individual donor's marginal tax bracket. An efficient incentive would stimulate the greatest amount of giving for the least cost. The cost is represented by tax revenues foregone. In fiscal 1975, $4.9 billion of tax revenue was foregone in lieu of the charitable deduction. The deduction system, if it was efficient, should have elicited contributions in an amount at least as great as $4.9 billion.

The question of how efficient is the deduction system is determined by the price elasticity of charitable giving. A price elasticity is simply a way of expressing how responsive a consumer is to a price change. A price elasticity of 1.0, in the present context, implies that giving is reduced in proportion to the price rise. An elasticity of less than 1.0 indicates that a price increase would elicit a reduction in giving by an amount proportionately less than the fall in the price of giving. Elasticities greater than 1.0 imply a reduction in giving that is proportionately greater than the price increase.

For example, a person in the 40 percent marginal tax bracket incurs a price of $60 for a $100 gift to charity under the current charitable deduction. An elasticity of 1.0 implies that if the deduction were removed his price would rise to $100, and the individual would reduce his check to charity to $60 (the other $40 now being paid in taxes). Thus, in this example, the removal of the deduction reduced the total gift to charity by the amount of the price change, assuming that the government did not make the $40 in increased taxes available to charity. A price elasticity greater than 1.0 would reduce the gift by more than $40, while an elasticity less than 1.0 would reduce the gift by less than $40.

Thus, a price elasticity of 1.0 implies the present deduction has the same effect on total funds received by charity as would a direct federal grant in the amount of the foregone taxes. That is, charity will receive the same aggregate amount of money regardless of whether a deduction or a direct federal subsidy program were utilized, assuming that the federal government expends the same amount under either system. Elasticities of less than 1.0 imply that the deduction is less efficient than a direct subsidy would be; therefore substitution of a direct grant system would increase funds received by charity if the government held its expenditure constant. Elasticities of more than 1.0 imply that the deduction is an efficient incentive that elicits more funds for charity than are expended through the deduction; a direct matching grant program would have to match that efficiency and federal expenditures held constant in order to insure that charities would continue to receive the same aggregate federal and private funds.

Studies by economists have focused on ascertaining the pure price elasticity of the deduction itself. Thus, they give some estimate for determining the impact on total charitable giving if the charitable deduction were eliminated, *and the federal government did not substitute any other program to insure that the increased federal revenues were directed to charity*. Obviously, mere removal of the deduction would reduce total funds received by charity (unless the deduction has no incentive effect at all), since the federal government would have terminated its participation in the joint private-federal system of transferring funds to charitable organizations. But it should be kept in mind as the economists' studies are reviewed that they are focusing only on the effects that complete *removal* of the federal program would have, not on the effects that a *change* in the method of delivering the federal funds to charity would produce.

Unfortunately, economists who have studied the matter differ widely as to what the correct estimates of the price elasticities of the deduction in fact are. This is in part due to the fact that exact measures are not feasible. An elasticity is an estimate and being an estimate it can vary widely depending upon one's assumptions and one's data base.

The following material reviews briefly the findings by various economists (in chronological order) as to the price effect of the deduction. In each case, the implications of the economist's findings for the proposed matching grant system are considered.

Harry Kahn[45] examined the efficiency of the charitable contribution deduction as an incentive to charitable giving by looking at contributions changes and tax changes in the 1940s and 1950s. Focusing especially on donor reactions to introduction of the general standard deduction in 1942 and the numerous rate changes in the two decades, Kahn concluded:

1. At lower-income levels, contributions are almost completely unaffected by tax provisions.
2. In the middle-income brackets, contributions display relatively little sensitivity to tax rules.
3. At the highest income level, the level of contributions is markedly affected by tax provisions, especially the existence of the deduction.[46]

Kahn's findings, if accepted, indicate that a large portion of the federal funds foregone through the charitable contributions deduction is wasted if its purpose is to induce larger contributions to charity. Lower- and middle-income donors would give about the same amount to charity without the deduction as they do with the deduction. Since those with AGI's of less than $15,000 contribute more than one half the total contributions to charity,[47] a shift of the revenue loss from the deduction to the proposed federal matching grant system would obviously increase substantially the aggregate amount of funds charity receives from these donors. Kahn did not assign a definite price elasticity to the deduction for the higher income donors for whom he found the deduction had an incentive effect. But to the extent that elasticity was less than 1.0, the shift to the direct matching grant system would likewise increase total funds—federal and private—as the result of gifts by these donors.

Michael Taussig[48] produced the next detailed study of the efficiency of the charitable contributions deduction. Taussig focused especially on the tax reduction effected by the Revenue Act of 1964. If the deduction had a marked incentive effect for donors, then the reduction in rates should have produced some changes in the giving patterns of high-bracket donors (for whom the price was increased from .09 to .30).[49] Taussig's studies could discern no such impact.[50] He concluded, with a number of cautionary warnings about the adequacy of the data, that the deduction was markedly inefficient. His overall conclusion was that it had no incentive effect at all for donors whose tax brackets were below 58-60 percent. In tabular form, Taussig's analysis showed the following price elasticities for various AGI brackets:

Table 5

Income Class (thousands)	Price Elasticity
$ 0-25	0
25-100	0
100-200	0.10
200-500	0.06
500 and over	0.04

Source: Michael Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," 20 National Tax J. 1 (1967), p. 6 (Table I).

Taussig's figures imply that the deduction provides virtually no incentive to charitable giving and is a wholly inefficient method of encouraging charitable donations. Under Taussig's analysis, at 1968 levels, the federal subsidy of $2.4 billion was operative as an incentive for the less than three tenths of one percent of all U.S. taxpayers who donated about $1.2 billion (or 10 percent) of the total contributions by individuals. But even this incentive was hardly significant. The $100,000-200,000-income-bracket donors would have reduced their giving by only 10 percent, the $200,000-500,000-bracket donors by only 6 percent, and the $500,000-and-over income bracket by only 4 percent as the result of removal of the deduction. Under this analysis only slightly over $81 million in charitable giving was due to the deduction incentive. This means that in 1968 the federal government gave up $2.4 billion in tax revenues to elicit an additional $81 million for charity.[51]

A direct matching grant that would have directed to charity the $2.4 billion in federal funds wasted in 1968 would have increased aggregate funds by just this amount. Instead of the $12.6 billion in combined federal-private funds that charity in fact received via the deduction mechanism, a direct matching grant system would, according to the Taussig data, have delivered $14.9 billion to charity—an increase of over 18 percent.

Taussig urged caution in the use of his conclusions, however, and subsequent studies have found greater efficiency in the deduction than his studies indicated.

Professor Robert A. Schwartz[52] in 1970 published a study estimating elasticities of the charitable deduction. His estimates varied widely from those so far discussed. Schwartz found price elasticities greater at low-income than at high-income levels:

Table 6

Income Class (thousands)	Price Elasticity
$ 0-10	0.68
10-100	0.76
100 and over	0.41

Source: Robert A. Schwartz, "Personal Philanthropic Contributions," 78 J. of Pol. Econ. (1970) p. 1,281.

Professor Schwartz's conclusions ran directly counter to previous studies in terms of the pattern of price elasticities. But he agreed with prior studies in finding a price effect of less than 1.0 at all income levels.

Thus, under Professor Schwartz's data, substitution of a direct matching grant would increase aggregate giving to charity, although the giving from lower-income donors would not be increased nearly so substantially as the Kahn-Taussig conclusions would indicate. Conversely, giving by high-bracket donors would be substantially increased by the substitution of the direct matching grant system.

The *U.S. Treasury Department's* "Tax Reform Studies And Proposals,"[53] submitted to Congress in early 1969 also supported the view that the price elasticity of the deduction was less than 1.0. The Treasury made several proposals dealing with the charitable contribution deduction. The most important of these was a recommendation to allow the charitable deduction outside the standard deduction, but subject to a 3 percent floor. This proposal was designed to eliminate the wasteful effects of the deduction for relatively small gifts. But, coupled with an increase in the limit on the deduction to 50 percent of AGI, it was also designed to provide an incentive for giving significant amounts. Of interest is the Treasury's conclusion that the package of proposed changes, while increasing revenues by a net $1 billion per year, would have reduced charitable giving by only $100-$300 million a year *at most*. In other words, for the taxpayers affected, the government was spending $1 billion to obtain at best an extra $300 million of private funds for charity.[54]

Important here is the Treasury's assumption with respect to the price effect of eliminating the deduction for some taxpayers and reducing it for others. Treasury economists found a price elasticity of 0.5 (that is, the taxpayers affected by the proposal would reduce charitable giving by one half of the additional tax cost).[55] This price effect was significantly higher than any observed by Kahn, Taussig, or Schwartz for the highest-bracket taxpayers, although less than Schwartz's elasticities for under $100,000 income brackets. But using this elasticity for all income brackets, the Treasury concluded that the deduction is a markedly inefficient system for delivering dollars to charity.

Using the Treasury conclusion (a price elasticity of 0.5 in all income brackets), an expenditure of the $2.4 billion of federal funds in 1968 through the proposed direct matching grant system rather than the tax deduction would have increased total private-federal funds given to charity by itemizers from $11.1 billion to almost $12 billion, and total giving could have gone from $12.6 billion to between $13.5 and $14.0 billion.

Professor Gerard M. Brannon[56] recently completed a study on the effect of the charitable contributions deduction on the level of total charitable giving. He concluded that the price elasticities shown below in Table 7 were justified by the data and by observable taxpayer responses to tax changes:

Table 7

AGI (thousands)	Price Elasticity
$ 0-5	0.28
5-10	0.26
10-15	0.68
15-20	0.91
20-25	0.99
25-30	0.87
30-50	0.94
50-100	0.97
100-200	1.08
200-500	1.17
500-1,000	1.24
1,000 and over	1.15

Source: Gerard M. Brannon, The Effect of Tax Deductibility on the Level of Charitable Contributions and Variations on the Theme (Fund for Public Policy Research, 1974), p. 10, (Table 4).

Brannon concludes with respect to the efficiency of the deduction: "Since more than half of contributions come from the brackets below $15,000 where elasticities are quite low, the revenue loss from deductibility on the whole will be larger than the effect on deductions."[57] This simply implies, as was stated earlier, that a direct federal subsidy would provide charity with more money from these donors than it receives under the deduction system. High elasticities for high-income groups imply, on the other hand, that these donors find a large incentive in the deduction, and a direct matching grant system would have to provide an equally large incentive to hold contributions from these donors constant. On an overall basis, Brannon concluded that "about 80¢ goes to extra charitable contributions for each $1.00 of revenue lost," a result that he concludes "is not spectacularly good nor is it very bad."[58]

Brannon's study suggests that a direct matching grant system would improve the overall efficiency of the federal funding mechanism. More aggregate funds will go to charity than is the case under the present system. But his data also indicate that there will be a redistribution of combined private-federal funds from those charities favored by the over-$100,000-AGI donors to the charities supported by the under-$100,000 contributors.

Thus far, all of the studies considered have found that the tax deduction is overall an inefficient mechanism for inducing private contributions to charity. Each study has differed as to the exact price elasticities to be assigned to particular income levels. But, on the basis of each of these analyses, the proposed direct matching grant system should provide more aggregate funds to charity than does the deduction system, assuming that the federal share equals the revenue loss from the deduction.

Professor Martin Feldstein[59] has produced the first study that indicates that the tax deduction constitutes an efficient mechanism for encouraging private gifts to charity. The price elasticities found by him differ markedly from any of the studies produced to date:

Table 8

AGI (thousands)	Price Elasticity
$ 0-10	1.796
10-20	1.035
50-100	1.132
100 and over	0.290

Source: Martin Feldstein, "On the Effects of the Income Tax Deduction Treatment of Charitable Contributions: Some Preliminary Results," paper prepared for the Commission on Private Philanthropy and Public Needs, Sept. 1974, p. 12-22.

Professor Feldstein's study focused primarily on AGI classes between $4,000 and $100,000 (the low price elasticity for over-$100,000-AGI donors is surprising, and we should, he cautions, "remain agnostic" about elasticities over $100,000 and under $4,000).[60] It is important to examine the implications of his findings for the proposed direct matching grant system.

For the $10,000-15,000 AGI bracket, where the average marginal rate is 20 percent, Feldstein's study implies a reduction in giving of 24 percent.[61] This means that whereas under present law a $100 gift by donors in this bracket represents an $80 private gift and a $20 federal matching contribution, removal of the deduction would reduce the donor's private gift to $76. The critical questions are thus:

1. What does the government do with the $20 of increased revenues?
2. If the federal government makes available all or part of the $20 under a federal matching grant system, will the donor, in response to this incentive, increase his private gift back to $80 (or more)?

Feldstein's analysis supports the view that if the government simply uses the increased revenues from repeal of the deduction to implement a general rate reduction, charity will suffer a net decline in donations received. Thus repeal of the deduction in 1968 would have reduced charitable contributions by itemizers from $11.1 billion to $7.2 billion, a reduction of $3.9 billion. If the government used the $3.3 billion revenue gain to reduce tax rates, giving would only have increased to $7.3 billion.[62]

This, of course, simply means that a general rate reduction is not a potent incentive to charitable giving. The critical question is what would charity receive in the aggregate if repeal of the deduction were accompanied by a simultaneous introduction of the direct matching grant system. The material in pages 2467 and following provides data with respect to this question.

Professor Feldstein's study concludes with an important point for policy makers who seek to ascertain the efficiency of the present charitable deduction: "Those who wish to assess the impact of our tax system on charitable giving must balance the current results against the conclusions of previous research on this subject and must consider the important factors that have been neglected in all of this work."[63]

Martin Feldstein and Charles Clotfelter[64] have also completed a recent study, based on different data sources. Whereas Feldstein, in the study discussed above, utilized tax return data (which excluded the 60 percent of taxpayers who do not itemize deductions), the Feldstein-Clotfelter ("F-C") study used household survey data "to relate charitable giving to economic income, wealth, tax rates and personal characteristics."[65] Using this data base, the study found somewhat lower price elasticities than the Feldstein study. But it likewise concluded that in all income brackets, the price effect of the deduction exceeded 1.0 (ranging from 1.07 to 1.55).[66] On an aggregate basis, the F-C study concluded that in 1968, had the deduction been repealed and the revenue used for a rate reduction, charitable giving would have declined by 26 percent (as compared with 34 percent under the Feldstein analysis).[67]

The F-C study in this regard raises the same questions for the direct matching grant proposal as does Feldstein's analysis. But another aspect of the F-C study is relevant to the impact that a direct matching grant system could be expected to have on charitable giving.

The F-C study calculated the effects of alternative changes in the income tax treatment of charitable contributions. Two of those alternatives involved direct matching grants: one, a flat federal matching grant equal to 25 percent of contributions received by charity and the other a 43 percent flat matching grant. In each simulation an across-the-board change in the tax rates was also assumed in order to keep federal tax revenues constant.[68] For the sample of donors studied, the 25 percent flat matching grant system results in increased charitable giving by individuals with under $10,000 income and slightly reduced giving by those with income above $10,000. Overall giving by the donors sampled was reduced by only 10 percent. On the other hand, the 43 percent flat matching grant increased giving in all groups up to $20,000 of income and increased overall donations to charity by these donors by 1 percent.

The above study did not purport to estimate the effect in *total* giving under either matching grant percentage. Subsequently, Professor Feldstein presented such an estimate to the Advisory Committee of the Filer Commission. His estimates showed that the 43 percent flat matching grant system, had it been in effect in 1970, would have increased total contributions recieved by charity from almost $16.9 billion to $18.3 billion.[69] This result is what one would expect from Professor Feldstein's previous studies. For the federal government under the 43 percent matching grant system would have increased its appropriation for charity from the $3.6 billion it in fact expended via the deduction to $5.4 billion. The $1.8 billion increase thus picked up not only some $1.1 billion in reduced *net private* giving (resulting from removal of the deduction) but also added an additional $700 million in federal funds.

The Feldstein analysis does make it clear that a federal matching grant system, properly structured, can produce the same revenues for charity even if federal spending is held constant. If federal funding of the program increases, charities obviously benefit correspondingly. Projections supporting both of these conclusions are set forth on pages 2467 and following.

Conclusions: Economists' Studies. Professor Feldstein in October 1974 presented the results of his studies to a group of economists who served on the Advisory Committee to the Filer Commission.[70] After taking into account the problems that Feldstein himself had identified; the consensus of the economists was that at the upper income levels policy makers who were considering changes in the charitable contributions deduction would be ill advised to assume that the prior elasticity of the deduction was significantly less than 1.0. That is to say, for purposes of considering the effects of changes in the present deduction, or a shift to an alternative non-tax system, one should assume that high-income donors would write checks to charity that would be reduced by $1 for each $1 of increased taxes they were required to pay. However, the economists differed among themselves on the correctness of Feldstein's conclusions as to lower-income individuals. Some felt that the price elasticities for this group of donors were significantly lower than implied by the Feldstein study. And it is difficult to square Feldstein's conclusions for lower-income donors with the fact that standard-deduction donors gave over $3 billion to charity in 1970 with no tax incentive at all.

The consensus view implied that if a direct matching grant system expended the same revenues for charity as is now foregone as a result of the deduction, aggregate contributions would equal those received at present by charitable organizations.

Survey data. Several surveys have been conducted to try to ascertain from charitable contributors their perceptions of the extent to which their giving is influenced by the tax deduction. It is useful to compare the results of these surveys with the economists' studies discussed above.

Peterson Commission Survey. The Peterson Commission presented testimony during consideration of the Tax Reform Act of 1969.[71] It had conducted a survey among 85 wealthy donors who had each given over $375,000 per year to charity in each of the five years preceding the survey. These donors were asked to state the effect a repeal of the deduction would have upon their giving to charity. The response indicated a median reduction in charitable contributions of 75 percent.[72]

Assuming that each of the responding donors in the Peterson survey was potentially in the 70 percent marginal tax bracket, the survey supports the Brannon conclusion that if the deduction were eliminated, high-bracket donors would write their checks to charity for their own private gifts in slightly smaller amounts than at present. These donors are now contributing $30 of their own funds to charity for each $100 check that they give. The Peterson Commission survey indicates that these donors would reduce their own private donation to $25 if the deduction were repealed *and no other action were taken by the government to encourage charitable giving.*

Michigan Survey. The Michigan survey, in response to the question, "Would people whose financial situation is about like yours give less if charitable contributions were not deductible?"[73] found that, aggregated across all incomes, 63.8 percent of the respondents would give the same amount. Although only 12 percent of those surveyed had incomes over $20,000, donors with incomes of less than $20,000 represent 93 percent of all itemzied returns which include some 68 percent of all itemized donations.[74] These data imply that some 68 percent of all itemized donations in 1968 received no incentive at all from the deduction.

The preliminary responses to the Michigan Survey are interesting. The responses of the 63.8 percent who said that they would not reduce giving if the deduction were repealed may imply that *private giving* would actually increase with repeal of the deduction. Presumably these respondents were saying that they would write the same check to charity without the deduction that they do with the deduction. But the present federal element would be removed with repeal and their actual private gifts would increase. Their responses correspond to the findings of Kahn and Taussig that there is little incentive in the deduction for lower-income persons.

The preliminary survey data do indicate that the percent of people who would give less if the deduction were repealed rises with income, a response that squares with Brannon's general findings.

The Michigan Survey Research Center in 1974 conducted a more extensive survey for the Filer Commission.[75] In general, the 1974 survey results were consistent with the 1973 preliminary survey discussed above. It found that donors were not nearly so influenced by the tax deduction for contributions to charity as Feldstein's analysis would indicate. On the other hand, the presence of the deduction clearly had some impact on increased giving. Thus, this survey data would justify rejection of Feldstein's conclusion that the tax deduction generates more giving to charity than it costs in revenue (that is, price elasticities in excess of 1.0); but it would also indicate use of price elasticities higher than those discerned by Taussig's study.

Income elasticities. The discussion thus far has dealt with only one of the elasticities—price—involved in the charitable contribution deduction. But there is another—the income elasticity—that must be taken into account in determining the impact of the present deduction and the proposed matching grant.

The income effect is associated with any price change and price elasticity. A price reduction means that a consumer, after buying the same amount of a good as before the price reduction, will have additional income for consumption. The price effect comes about because the price fall makes the consumption of this good more inviting while the income effect comes about because of the increase in dollars then available for consumption. This higher real income stimulates further purchases of the good with the lower price and of all other goods.

As with the price elasticities, there is little agreement among economists as to the proper value for the income elasticity to be utilized in evaluating the effect of the present deduction. The studies discussed earlier make the following estimates of the income elasticities associated with the removal of the deduction.[76]

Table 9

Feldstein[a]		Taussig[b]		Schwartz[c]	
0-10	0.674	0-25	1.31	0-10	0.28
10-20	0.846			10-100	0.92
20-100	0.906	25-100	1.99		
100+	1.377	100-200	3.10	100+	0.45
		200-500	2.54		
		500+	1.75		

a. Martin Feldstein, "On the Effects of the Income Tax Deduction Treatment of Charitable Contributions: Some Preliminary Results," paper prepared for the Commission on Private Philanthropy and Public Needs, September 1974.

b. Michael Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," 20 Nat'l. Tax J. 1 (1967), p. 6.

c. Robert A. Schwartz, "Personal Philanthropic Contributions," 78 J. of Pol. Econ. (1970), p. 1,279.

The income elasticities estimated by Feldstein are surprising. His income elasticity of more than 1.0 for over $100,000 indicates that if there were no federal income tax at all, then high-bracket donors would give a smaller percentage of their incomes to charities than would their lower-income counterparts. Or to put it another way, if the charitable contribution deduction were removed and a federal matching grant instituted, Feldstein's income elasticities indicate that lower-income donors would respond by giving relatively more of their after-tax disposable income to charities than would wealthy donors.[77] Why wealthy donors would respond in this fashion is unclear. If Feldstein's conclusions are accepted, one must concude that wealthy persons are more stingy than lower-income individuals and that they are "generous" only when spending someone else's money.

Implications of studies for matching grant system. The removal of the deduction and the introduction of the matching grant involve elasticities working in opposite directions. The removal of the deduction would raise the price of the gift and reduce giving depending on the size of the elasticity. The introduction of a matching grant would reduce the price again and increase giving depending upon the associated elasticity. If the match were equal to the government's share under the deduction, the price would return to the same level as would the amount of giving (assuming the deduction and the match are perceived the same way by the donors, that is, their elasticities identical) and ignoring any extra incentive effects the structure of the match might create. But the direct match would rarely be equal to the government's share under the deduction system for any individual since the direct match is based upon the percentage of income given, while the deduction is based upon the donor's marginal income tax bracket, two wholly unrelated measures.

For example, assume an individual in the $10,000-20,000 income bracket has a marginal tax rate of 20 percent. This means that each $80 gift to charity is at present matched by the government with $20 in every $100 check he writes. The removal of the deduction would raise the price of his charitable contribution, and, under Feldstein's data, he would reduce his own gift to $76. But the direct match reintroduces a government incentive or a price reduction for charitable gifts. Under a progressive matching schedule, this incentive is a function of the percentage of his income donated to charity and is independent of his income tax bracket. If the hypothetical donor was contributing 10 percent of his income to charity, he would receive a matching grant of 50 percent of his charitable gift. Thus his $76 check would trigger a $38 government matching grant, and the charity would receive an aggregate $114 rather than $100 under the present system. On the other hand, if the individual only gave 1 percent of his income to charity, then the federal match would be only 5 percent of the $76 gift ($3.80), and the total funds to charity would have dropped from $100 to $79.80. But these examples ignore the income effect. Each donor now has $4 more for consumption since he has reduced private giving by more than his increased taxes. But the presence of the direct match then creates a price reduction to encourage the contribution of this $4 to charity.

Thus, it is apparent that the gifts of some donors will result in more funds for charity and the gifts of others less than under the present system. But, as the above example makes apparent, a progressive matching grant system creates a potent incentive to increase private giving. The donor who gave only 1 percent of his income to charity, but really wants charity to receive a total of $100, is given a very visible incentive to increase his private gift so as to trigger a larger federal matching grant.

Chapter III sets forth estimates of the impact of the removal of the present deduction accompanied by introduction of the direct matching grant system with respect to both aggregate funds given to charity and responses by donors in various income brackets. In making these estimates we adopted a price elasticity of 1.0 throughout the income scale. This seemed a conservative approach, given the conflicting data discussed above. The 1.0 elasticity at lower-income levels is higher than that assigned by a majority of those who have studied the problem; at the upper-income levels it is lower than the extreme position adopted by Feldstein but well above that determined by Taussig.

Objections to Change and Responses Thereto

The Direct Matching Grant Program Contains Its Own Equity Problems

The wealthy control too much of the federal funds. Although the proposal represents a decided advance over the inequitable regressivity of the tax deduction, it is open to the criticism that it has not gone far enough because the wealthy still control more than their democratic share of federal funds simply because they can give larger dollar gifts to charity. This results because the match is given as a percent of the contribution. It is necessary that the match be computed in this manner because just as we saw how it was less of a sacrifice for the rich to give each dollar to charity, likewise the rich value each dollar of incentive-reward less. If equal sacrifice is to be measured as a percent of income contributed, then to be logically consistent and to offer an effective incentive, equal reward should be measured as a percent of the donation.

However, the matching grant proposal can be easily modified in order to insure that the wealthy control smaller absolute dollar amounts than is true either under the present system or under the matching grant schedule set forth in Chapter I, p. 2418.

One method by which this result could be accomplished would be to change the progressive matching grant schedule so that individuals with higher incomes would be required to donate larger percentages of their income in order to receive percentage matches equal to those generated by donors with lower incomes. In other words, a floor could be set for each income category and only if donors in that income category made gifts in excess of the floor would they qualify for the federal matching grant schedule. Similarly a flat matching grant system could be modified to reduce the control over federal funds held by upper-income groups. Either alternative proposal, of course, would have the effect of markedly reducing the incentive of the direct matching grant system for upper-income individuals. In turn, if federal funds were held constant and we accept Professor Feldstein's conclusions as to price elasticities for lower-income donors, while aggregate funds to charity would remain constant, funds going to charities favored by the upper-income groups would be reduced.

The proposal examined in this study attempts to balance equity and incentive considerations, but this balance itself reflects a value judgment. The important point is that those who perceive an advance in equity by reducing the control of federal funds by the wealthy can easily accomplish that goal within the context of a direct matching grant.

Another method by which the total amount of dollars that the wealthy could control could be reduced would involve a shift in the matching grant schedule from percentages to absolute dollar amounts. Under such a system, the rich could direct more government funds than the poor only if they contributed larger percentages of their income to charity. Again a matching grant schedule could be devised to achieve this result. Once again, the tradeoff for increased equity (here perceived as reduced control by the wealthy over federal funds) is a reduced incentive to give by the group that present data show gives the largest percentage of income to charity.

A matching grant system is open to the charge that it contains an inequity if inequity is defined to mean excessive control by the wealthy over the total amount of federal funds made available through the direct matching grant system. However, as set forth at the beginning of this chapter, this is not the only standard of equity that may be relevant. Further, even under this equity standard, the proposed direct matching grant schedule represents a marked improvement over the present deduction system. And it achieves improvement while maintaining a potent incentive for contributors at all income levels to give a large percentage of that income to charity. Those who seek to reduce the control of the wealthy over federal funds even more than does the proposed matching grant schedule must be prepared to accept the fact that a reduced incentive accompanies that decision, with a resulting radical reallocation of funds among recipient charitable organizations.

Either the suggested progressive matching grant schedule based on relative effort or a flat matching grant steers a middle course between giving the wealthy an unacceptable degree of control over the federal funds and providing an adequate incentive to give for persons at all income levels.

The notch effect. A progressive matching grant schedule does contain a "notch" effect. Thus a person who gives $100 to charity which represents 0.999 percent of his income may double the amount of the federal matching contribution by increasing his giving by only $1. This "notch effect" is created by the fact that the proposed sliding matching grant schedule is not on a continuous scale. If it were continuous, there would be no extraordinary advantage for a donor to give a few dollars more in order to move up to the next matching grant percentage. But considerable complexity is required in order to fine tune the scale to virtually eliminate the significance of the notch effect.

While the "notch effect" thus may be perceived as creating an inequitable effect, it can be justified by the additional incentive that the sharp increases in the matching grant create. This, however, is simply another way of saying that a progressive matching schedule offers a marked incentive to give a greater percentage of income to charity. Even within a particular matching grant bracket, there is an incentive to give more dollars because the percentage is a function of the amount given as well as of the relationship of that amount to the donor's income. Thus a $100 gift by a person in the 5 percent bracket triggers a $5 federal matching grant; but a $200 gift by that individual who is still within the 5 percent bracket would produce a $10 federal matching grant. Obviously, however, the closer that the donor comes to the "notch" the greater is the incentive to give the extra dollars that will be required in order to move up to the next higher matching grant bracket.

An example will illustrate the "notch effect" in a progressive matching grant schedule. Suppose a $10,000-per-year individual proposes to give $190 to charity. This gift places the donor in the 10 percent matching grant bracket and the government will provide a matching grant of $19. If the individual gives $11 more to charity (for a total of $201) then his matching grant percentage increases to 15 percent and the federal matching grant goes from $19 to $30.15. In effect, his additional $11 gift has been matched at a 101 percent rate. Once the donor is beyond the notch, then the incentive remains constant at the 15 percent rate.

This notch effect can, of course, be substantially alleviated or eliminated. One technique would involve application of the federal matching percentage to donations that fall within a specified bracket. Hence, even though a donor gave 10 percent of his income to charity, the first 1 percent bracket would be matched only at 5 percent, the next percentage bracket at 10 percent, and so on. Thus, in the above example, $10 of the increased $11 gift would continue to have been matched at the 5 percent rate, and only the $1 above $200 would have been matched at the 10 percent rate.

Adoption of a flat matching rate applicable to all gifts obviously eliminates notch problems.

The "notch effect" does create inequities. The question for the policy maker is whether that inequity outweighs the reduced effectiveness of the incentive if the progressive matching schedule is modified or eliminated.

The Use of a Ceiling on the Matching Grant System Reduces the Effectiveness of the Proposal as an Incentive

Under a progressive direct matching grant system, donations up to 10 percent of income would be matched at a constantly increasing rate. But, donations of 10 percent of income or more would be matched at the same flat 55 percent rate. Hence, the constantly increasing price incentives would be operative only for gifts up to 10 percent of a donor's income, at which time a constant price effect would be operative. (In a flat rate system, of course, a single percentage is applicable to all gifts.)

For those who are primarily concerned with the incentive effect of the deduction, use of the ceiling may be seen as having an undesirable and adverse effect on the otherwise potent incentive effect of the matching grant system. Thus, it is demonstrable that the amount of giving represented by those who at present contribute more than 10 percent of their AGI to charity is quite large in dollar amounts, although the number of persons who give more than 10 percent of AGI is small.[78] This fact, it could be asserted, argues for continuing to use an increasing matching grant percentage above the 10 percent level suggested in the schedule in Chapter I.

The imposition of the ceiling is justified for two reasons, both of which are based on the fact that the proposal assumes a limited amount of federal funds (that is, the present revenue loss from the deduction) with which to perform the match. First, it is important that the matching percentage for gifts that represent a small percentage of income be set at a figure that is large enough to be viewed by these individuals as an incentive. Those who give 0-2 percent of their income to charity comprise some 47.7 percent of all itemized deductions returns.[79] In order to encourage these individuals to give a larger percentage of their income to charity, it is essential that the match of the gift in the 2-3 percent category be significant. Obviously, creation of an incentive of sufficient magnitude to increase giving at these levels requires expenditure of a significant portion of the federal funds available for the matching grant system.

Second, if a progressive matching grant schedule is adopted, it is important that the differences in the increasing matching percentages be large enough so that a donor perceives a marked advantage to giving a higher percentage of income to charity. This incentive effect is a significant attribute of a progressive matching grant formula. But, given the fact that there is a ceiling on the funds available for the federal matching grant system, it is obvious that a ceiling on the matching formula is likewise required.

It should also be emphasized that the existence of a ceiling does not imply that donors have no incentive to increase their charitable giving once they have achieved the 10 percent level. All gifts over 10 percent of income are matched at the 55 percent rate, so that increased dollar amounts of giving will trigger larger dollar federal matching grants. The incentive effect is less potent, as is true of any flat matching grant system, but it is not non-existent. And, as noted above, the proposed system even for those who give the highest percentage of their income to charity represents a marked improvement over the present deduction system. Under the present system, as the donor increases the percentage of income donated to charity, his marginal tax rate is reduced and thus the incentive effect of the deduction goes down as he makes a greater relative effort for charity.

The Proposed Direct Matching Grant System Will Involve Too Much Federal Control Over Charitable Organizations

Two concerns are expressed in the argument that a matching grant system will result in too much federal control over private charitable organizations. The first is a judgment that the federal government will be unwilling to grant directly appropriated funds to charitable institutions with no strings attached. The deduction, however imperfect it might be in other respects, is seen to achieve this end.

The argument is not necessarily about the desirability of restricted versus unrestricted funds. For example, colleges and universities frequently advance the government control argument. But in fact 70 percent of the funds received by higher education from living individuals are restricted as to use.[80] If this be the case, the control argument is not one over the fact of control, but over who will exercise the control over the federal share. It should be noted, moreover, that the Education Amendments of 1972 indicate a considerable willingness by Congress to provide unrestricted general purpose funds to institutions of higher education.[81]

The other aspect of the control argument is a quantitative one. Charitable institutions may be fearful of having the federal funds represented by the deduction subjected to the annual appropriations process. The concern here is that in the battle for allocation of federal funds, charitable institutions will not have the political power to hold the funds made available via the deduction. But the appropriations process aspect of the argument does not stand up under scrutiny. After all, Congress has examined the charitable contribution deduction with varying degrees of intensity 4 times in the last 19 years.[82] Thus, tax appropriations for charity have been examined periodically by Congress and adjustments made in the federal funds that go to charity. The question is whether that examination could go on in a more rational context under a direct expenditure system, even if one decided not to conduct it every year. (See page 2431.)

Furthermore, the recently enacted Congressional Budget Act of 1974[83] insures that charities are going to be required to defend their appropriation via the tax-expenditure process and perhaps in a more rigorous fashion than under a direct matching grant system. Under the new act, "tax expenditures"—of which the charitable contributions deduction is one—are subject to the jurisdiction of the Congressional Budget Office and the budget committee, as are direct expenditures through the regular appropriations process. Hence the real question for charitable organizations is not whether they will be subject to the appropriations process or not, but whether the appropriations that they in fact receive will be handled in a rational and orderly fashion.

Finally, the proposed matching grant proposal should alleviate some of the concerns over federal control. First, donors, rather than the government, are given the power to control the objects and uses of the federal funds made available through the matching grant system. Second, it is recommended that appropriations for the matching grant program be made on a 5- or 10-year basis rather than annually, so that charities can be assured of a predictable level of federal funding over a period of time greater than one year.

Donors Will Reduce Their Giving to Charity Because of Repeal of the Deduction

The effects of the proposed matching grant system on donors are considered in Chapter III.

Some Types of Charitable Institutions Will Suffer Reductions In Funds Received Relative to Other Kinds of Charitable Institutions

The effects of the proposed direct matching grant system on charitable organizations by types of organizations are considered in Chapter IV.

The Direct Matching Grant System Creates Too Many Administrative Problems To Be Feasible

The resolution of administrative problems posed by the direct matching grant system is considered in Chapter V.

The Proposed Direct Matching System Is Unconstitutional Because Direct Grants Would Be Made to Religious Organizations

The constitutional issues involved in both the present tax-deduction system and the proposed direct matching grant system are considered in Chapter VII.

III

EFFECTS OF CHANGE ON DONORS

In proposing a change from a system of tax deductions to one of federal matching grants for charitable contributions, it is essential to determine what effect the change will have on donors' giving behavior. The expected change in private giving can be broken down into three components for analysis: the price effect of repealing the deduction, the price effect of simultaneously offering matching grants, and the added incentive resulting from the use of a matching schedule offering increasingly larger percentage matches as the donor increases his gift. As pointed out in discussing the efficiency of the tax deduction as an incentive, economic measurement of the price effect has been undertaken by various researchers with differing results. By using available data, we will estimate in this chapter the predicted behavior of donors reacting to the price change.

Effect of Repeal of Deduction Alone on Private Giving

In measuring the effect repealing the deduction would have on private giving, it is first necessary to specify what is meant by "private giving." Under the deduction system, the check that the donor writes for charity does not reflect his out-of-pocket cost for the sake of charity. When the donor settles his tax bill with the federal government the following spring, assuming that he itemizes, he will be reimbursed for a certain percent of his contribution, that percent being determined by his marginal tax rate. For example if a 40-percent-bracket taxpayer wishes charity to receive $100, he will write a check for $100, because of which his tax bill will be reduced by $40. The donor's own private gift to charity is therefore only $60, and the government's share is $40. By repealing the deduction, the government will no longer contribute its share to charity and, therefore, the donor's check will no longer include the government's $40. The question is whether the taxpayer will still contribute his $60 or will his private giving be reduced as a result of the government's withdrawing its contribution.

Chapter II of this study summarized the results of the various analyses attempting to answer this question. They all agree that the change in private giving varies with the income of the donor, although there is no agreement on the exact size of the changes. Feldstein[85] predicts that private giving will be reduced somewhat, from $7.8 billion to $7.2 billion (at 1968 levels), a reduction in private giving of only 6.4 percent. Brannon's study,[86] on the other hand, implies that donors will increase their private giving, especially among the low- and middle-income groups. His study indicates that donors will pick up some of the funding lost to charities due to the government withdrawing its contribution and will reduce the size of the check written to charity by less than their increase in taxes. The Michigan survey and other empirical evidence[87] also indicate an increase in private giving, some data implying that donors will pick up almost all of the government's share.

The argument that repeal of the charitable deduction will reduce aggregate private giving to charity must be recognized, then, not so much as dealing with the maintenance of the level of out-of-pocket private giving, but with ensuring that federal funds will continue to be available at the same level as provided through the deduction mechanism. If Feldstein's data are accepted, then the incentive effect of the matching grant system need only induce $600 million (at 1968 levels) of incremental giving to insure that charities in the aggregate receive the same total funds as at present.

General Effect of Repeal of Deduction Coupled With Simultaneous Institution of Matching Grant System

Instituting the matching grant system will return to charities the government funding equal to what it is under the deduction system. Assuming that the price effect of the match is the same as the deduction, since the government is spending the same amount of money, the average price of giving would return to what it was with the deduction. But the government's share with the match would rarely be equal for any individual to what it was with the deduction. This is because the match is based either upon the percent of income given or the dollar amount donated, while the deduction is based upon the donor's marginal income tax bracket, two wholly unrelated measures. Tables 10 to 12 show what effect these individual changes in price will have on total giving to charity.

Before analyzing the tables, however, it is necessary to understand why it is reasonable to assume that the price effect will be the same for the match as it is for the deduction. We know that the promise of a tax savings acts, to some extent at least, as an incentive to contribute to charity. What do we know about the effectiveness of a matching grant as a stimulus to giving? Matching grant programs already in effect in the United States provide some basis for predicting donors' responses to the proposed matching grant system.

The practice of offering matching grants is by no means a new approach to raising funds for charitable organizations. Its effectiveness as a fund-raising technique is evidenced by its increasing popularity with corporations who offer employee matching grant programs; with charitable foundations, who offer recipients challenge or matching grants; and with the federal government, which currently offers private, nonprofit organizations matching grants through the National Endowment for the Arts and the National Science Foundation.

According to survey data gathered by the Council for Financial Aid to Education, in the years since 1954, when General Electric became the first company to offer to match its employees' gifts to educational institutions, the matching gift plan concept has grown steadily in acceptance and scope, and it continues to increase in popularity.[88] The latest available information indicates that approximately 540 companies now have such plans in operation and that the number is continuing to grow.[89] Three out of four of the corporate matching gift programs are restricted to employee contributions to colleges and universities. In those cases where the range of donees is extended, companies will usually add hospitals and cultural institutions to the list of matchable recipients.[90] In 1970, employees contributed $10 million to these charitable organizations through their employers' matching gift program. Companies usually match employee gifts on a dollar-for-dollar basis, but because of program limits with regard to the maximum gift matched, the total amount of corporate matching gifts was estimated at slightly over $9 million.[91]

There is no sure way of knowing how much of this annual $19 million would have been given to charity if the corporate matching gift programs had not been in existence. A 1969 survey by the National Industrial Conference Board found that sponsoring companies were generally pleased and sometimes highly enthusiastic about the practice of matching gifts.[92] In many companies matching was instituted primarily to spur individual responsibility and participation in aiding education. Seemingly, such objectives are being realized, for the survey found a widespread conviction that a company's offer to match an employee's contribution stimulates giving, even though in modest amounts, and sometimes only after the program has been in force two or three years.

As used by philanthropic foundations, the concept of matching grants refers to conditional giving; the foundation's grant depends upon the beneficiary attracting funds from other sources. Sometimes the condition may be that a specific amount will be given as the final sum needed to achieve a stated goal. At other times it will be in the form of a challenge grant with the donor setting a particular time limit in which the match is to be met.

This mechanism for giving is not new; challenge grants were used to assist some of America's older institutions of higher education, including Bucknell, Wesleyan, Allegheny, and Rhode Island Colleges, during their formative years.[93] The use of this method of fund raising has increased with the rise of the modern philanthropic foundation. At the turn of the century Andrew Carnegie offered to provide libraries to selected communities throughout the country with the proviso that they supply matching funds. By the time of his death in 1910 he had helped establish 2,811 libraries. Perhaps the largest and best known of the foundation matching grant programs was begun in the early 1960s by The Ford Foundation. Grants totalling $252 million were offered to 12 universities and 57 colleges to further "their overall development as regional and national centers for excellence" if they could raise matching funds in specified amounts. The foundation claims with pride that the program has generated some $900 million in university gifts.[94]

The National Industrial Conference Board's 1969 survey of corporate giving also produced some interesting results on the effectiveness of the uses of challenge grants by foundations. Despite some reservations, the 151 companies cooperating in the survey generally favored challenge grants, a few to the point of using the technique themselves. A number of companies conceded that although it may be against their stated policy, there definitely is a tendency to be more receptive when judging appeals in which their contribution will trigger matching funds.[95]

The chief virtue of the challenge grant, executives feel, is its ability to generate more dollars than other fund-raising techniques. It has the power to broaden the base of support and it serves as an incentive to higher levels of giving. A number of companies recounted experiences of agencies and institutions enlarging their constituency, and reported that the technique seemed to arouse people to a sense of responsibility. Thanks to the challenge, indifferent college alumni have been brought back into the fold, and civic and community organizations have found new sources of voluntary support, including companies which had not previously participated in community projects.[96]

Federal grants that call for a match are widespread. While the lion's share of the match is typically supplied by state and municipal taxation, private funds are also sought. For example, in fiscal 1966 the U.S. Office of Fducation administered about 70 programs of grants and loans under various acts and titles, of which 26 required matching. The National Science Foundation and the National Council on the Arts and Humanities, the federal government's only two foundations, both employ this technique.[97]

When the National Endowment for the Arts was created, Congress included a unique matching grant provision in its enabling legislation.[98] Designed to encourage and stimulate increased private funding for the arts, the Treasury Fund of the Endowment allows private contributors to aid in the process of directing federal funds. Donations may be made to the Endowment, under its regular program guidelines, for the support of a nonprofit, tax-exempt, cultural organization which has been notified that the Endowment intends to award it a grant, such as a museum, a symphony orchestra, a dance, opera, or theatre company. When a private donation is received it frees an equal amount from the Treasury Fund, and the doubled amount is then made available up to 50 percent of the project costs.[99]

The Endowment's belief in the effectiveness and appropriateness of federal matching grant programs is demonstrated by its statement that "The Endowment encourages use of the Treasury Fund method as an especially effective way of combining federal and private support, and as an encouragement to all potential donors, particularly those representing new or substantially increased sources of funds."[100]

These examples of the pervasive use of matching grants as a successful fund-raising technique are suggestive of the probable success of a general federal matching grant program for all charitable contributions. They do not, however, provide conclusive proof since no statistics have been produced that verify the strongly held belief of fund raisers and corporate donors that such programs actually increase both the number of donors and the size of individual donations. It is possible that some of the success of individual fund-raising drives based on the offer of matching funds may be due to donors shifting funds from one charitable recipient to another. Even if this were true of some donors, however, it still does not negate the evidence that donors *do* respond to the offer of matching funds. There is reason to believe that if a federal matching grant were available for all charitable contributions, donors would be encouraged to increase their total level of giving to the general benefit of private charity in this country.

Estimates of Donor Responses Under Direct Matching System

Tables 10, 11, and 12 indicate the estimated effect changing the price of giving will have on the giving behavior of different income groups. They also compare the total amount charities received from donors who itemize under the deduction system and what charity can expect to receive from these same donors under the matching grant system.

Progressive Matching Grant Schedule

Table 10 reflects the estimated average contributions by adjusted gross income classes if the progressive direct matching grant schedule set forth on page 2418 were adopted. The table also shows the percent of the average conribution that is represented by the federal share, both under the direct matching system and under the deduction system. Table 10 assumes a price elasticity of 1.0 for the present deduction and for the direct matching grant. The income elasticities assumed are those developed by Professor Feldstein's study (see page 2444). Table 10 deviates from the proposed progressive matching grant system by using AGI as the income base rather than "total income." The use of AGI may result in an overstating of the federal matching contribution at the upper-income levels where exempt income (such as the excluded one half of capital gains) comprises an important element of total economic income. In addition the table only covers those who filed tax returns in 1970 and does not include, because of an absence of data, estimates with respect to giving by non-filers who also would be eligible for the matching grant. Table 10 is based on 1970 data and assumes that the federal government expended under the direct grant system the $3.5 billion in revenue involved in the charitable contributions deduction in that year.[101]

As Table 10 reveals, the direct matching grant system effects a substantial shift in control over federal funds from high-income to lower-income donors. Whereas, for donors in the under $5,000 AGI class, the average federal share is only $4 per return under the present system, that share is increased to $23 per return under the proposed system. Similarly, the average federal contribution for donors in the $1 million and over income category is decreased from $180,000 to $30,688. Moreover, while under the deduction system the average federal share ranges from 4 percent of total contributions at the bottom of the income scale to 70 percent at the top, the direct matching grant system produces a range of only 18-31 percent, with most brackets centering around the 18-21 percent level. Thus Table 10 provides rather dramatic evidence of the increased democratization that can be achieved by adopting a direct matching grant system.

Table 11 provides aggregate data on giving by AGI classes under a progressive direct maching grant system. It sets forth the estimated total giving by each AGI class under the new system and compares these results with the experience under the present deduction system. Table 11 is derived from the same data as Table 10 and employs the same assumptions.[102]

Table 11 graphically demonstrates both the inequity of the present system and the dramatic improvement in equity that is achieved by the direct matching grant system.

In 1970, those with incomes over $50,000 per year accounted for only one half of one percent of all tax return filers; they gave only 4.5 percent of all private funds (exclusive of the federal share) donated to charities, but they controlled 28.8 percent of the federal funds made available in that year. By contrast, those with under $10,000 AGI accounted for 68 percent of all returns filed; they gave 48.5 percent of all private funds donated to charity but controlled only 18.9 percent of the federal funds. In other words, although the under-$10,000 group gave twelve times as much to charity from their own private funds as did the over-$50,000 group, the higher income group controlled one and one-half times more federal funds than did the lower income group.

Table 10

AGI Class (thousands)	Number of Returns	Average Contributions						Percent of Contribution Represented by Federal Share	
		Direct Matching Grant System			Tax Deduction System				
		Private Share	Federal Share	Total	Private Share	Federal Share	Total	DMG System	Tax System
$ 0-5	28,348,864	$ 102	$ 23	$ 125	$ 102	$ 4	$ 106	18%	4%
5-10	21,537,824	194	51	245	192	26	218	21	12
10-15	13,686,641	244	59	303	249	46	295	19	16
15-20	5,531,877	305	69	374	307	88	395	18	22
20-50	3,568,860	465	110	575	466	226	692	19	33
50-100	3,353,157	968	251	1,219	1,012	1,012	2,024	21	50
100-500	74,631	3,322	1,220	4,542	3,131	6,057	9,188	27	66
500-1,000	1,795	21,489	9,755	31,244	21,934	50,139	72,073	31	69
1,000-10,000	655	78,754	30,688	109,442	77,676	180,000	257,676	28	70

Note: Federal share under tax system derived by applying average marginal tax bracket for itemizers in the AGI bracket to total giving by itemizers in the bracket.

Table 11

Total Contributions
(in billions)

AGI Class (thousands)	Direct Matching Grant System			Tax Deduction System			Percentage of Federal Funds Controlled by AGI Class Contributions		Percentage of Total Returns in AGI Class
	Private Share	Federal Share	Total	Private Share	Federal Share	Total	DMG System	Tax System	
$ 0-5	$2.892	$ .652	$ 3.544	$2.889	$ .116	$ 3.005	20%	3%	39%
5-10	4.179	1.098	5.277	4.150	.567	4.717	31	15	29
10-15	3.339	.808	4.147	3.402	.636	4.038	23	18	19
15-20	1.687	.382	2.069	1.702	.483	2.185	10	13	7
20-50	1.659	.393	2.052	1.655	.815	2.470	11	23	5
50-100	.341	.089	.430	.310	.405	.715	2	11	.05
100-500	.248	.091	.339	.262	.424	.686	2	12	.01
500-1,000	.038	.018	.056	.039	.090	.129	0.5	2.5	*
1,000 and over	.052	.020	.072	.051	.118	.169	0.5	2.5	*
	14.5	3.5	18.0	14.5	3.6	18.1	100.0	100.0	100

Note: Details may not add due to rounding.

Under the direct matching grant system this picture changes substantially. Based upon the same 1970 data, the over-$50,000 group would have contributed 4.6 percent of the private funds donated; they would have controlled 6.2 percent of the federal funds. The under-$10,000 group would have donated 48.8 percent of the private funds; they would have controlled 50 percent of the federal funds made available under the direct system. Obviously, a major shift in the direction of donor equity has been effected.

Under a direct matching grant system it is a simple procedure for the federal government to increase its funding. Thus, at 1970 levels a 50 percent increase in federal spending for charity (from $3.5 billion to $5.3 billion) would have been produced by the following matching schedule:

Percent of Total Income Donated	*Matching Federal Grant as Percent of Donation*
Under 1%	7%
1-2	14
2-3	21
3-4	28
4-5	35
5-6	42
6-7	49
7-8	56
8-9	63
9-10	70
Over 10	77

Similarly, if we would decide to provide a 100 percent matching grant for the largest relative effort for charity, the following schedule could be implemented:

Percent of Total Income Donated to Charity	*Matching Federal Grant as Percent of Donation*
Under 2%	10%
2-3	20
3-4	30
4-5	40
5-6	50
6-7	60
7-8	70
8-9	80
9-10	90
Over 10	100

Such a schedule would more than double present federal support for philanthropic organizations. As the stimulus of the federal matching share is increased, the amount of private giving likewise rises by virtue of the greater incentive offered for charitable donations.

The sample schedules illustrate points made earlier: One, under a direct matching grant system, the federal share can be directly increased by taking into account solely the merits of increased federal support for the program. Conversely, changes in the tax structure totally unrelated to charitable donations do not produce automatic changes in the fedeal match as is the case under the present deduction system. Two, the federal stimulus is directed solely to the act of charitable giving. An increase in the matching grant formula increases giving by donors quite apart from whether they are taking itemized deductions for other activities.

Flat Matching Grant Schedule

For comparative purposes it is helpful to examine the effects on donors of a flat matching grant schedule rather than one using progressive matching figures.

Table 12 sets forth donor responses if a 43 percent flat matching grant system were instituted. That is, the government would match all gifts to qualified charities in an amount equal to 43 percent of the donations. The table is based on 1970 data and assumes that federal spending for the charitable program has increased from $3.4 billion to $5.4 billion, an increase in the federal program of about 59 percent. Table 12 was developed by Professor Feldstein and employs the price and income elasticities developed by him. The donation base is adjusted gross income rather than "total income" so that gifts by upper-income donors may be somewhat overstated. Present non-filers of tax returns are not included in the table.[103]

Table 12 illustrates that a flat matching grant system would achieve much greater equity in control over federal funds than is the case under the present tax deduction system. The under-$10,000 AGI group comprised 68 percent of the taxpayers in 1970 and gave about 48.5 percent of all funds donated to charity (see Table 11). Under the 43 percent flat matching grant system they would have controlled 46 percent of the federal funds (compared with only 18.9 percent under the present system). Correspondingly, the one half of one percent of taxpayers in the over-$50,000 AGI brackets, who in 1970 controlled 28.8 percent of federal funds by gifts of only 4.5 percent of all private funds donated, would have their control over federal funds reduced to 3.7 percent on the basis of private gifts totalling 3.7 percent of all private giving.

Thus, the flat matching grant system achieves a very close correlation between the level of private giving by an income class and the percentage of federal funds that that class controls.

Comparison of Progressive Matching Grant and Flat Matching Grant

A comparison of the data under a progressive matching grant in Tables 10 and 11 and under a flat matching grant in Table 12 reveals the judgments required to be made by a policy maker in choosing between the two techniques.

First, it is obvious that the progressive matching grant mechanism represents a much more potent incentive to private giving than does a flat matching grant system. As Table 11 demonstrates, a progressive matching grant system that held federal expenditures constant would have generated in 1970 total combined private-federal gifts of $18 billion. On the other hand, a 43 percent flat matching grant system that required increased federal expenditures of about $1.8 billion produced $18.4 billion. It thus seems apparent that increasing the percentage of the federal match on the basis of relative effort has a potent incentive effect.

Another way of comparing the incentive effects of the two matching schedules is to compare the average gifts by AGI classes. For the $15,000-20,000 AGI group, the average private gift in response to a progressive federal match was $305, but it was only $289 in response to a 43 percent flat matching grant.

The tradeoff for a greater incentive effect in a progressive match is that the higher income groups control a larger share of the federal funds than they could under a flat match. Thus, the over-$50,000 AGI group would control 5

Table 12

AGI Class (thousands)	Number of Returns	Average Contributions			Total Contributions (billions)			Percent of Total Returns in AGI Class	Percent of Federal Funds Controlled by AGI Class
		Private Share	Federal Share	Total	Private Share	Federal Share	Total		
$ 0-5	28,350,064	$ 72	$ 29	$ 101	$ 2.041	$ .822	$ 2.863	39%	15%
5-10	21,540,224	189	78	267	4.071	1.680	5.751	29	31
10-15	13,686,661	235	101	336	3.216	1.382	4.598	19	25
15-20	5,532,010	289	124	413	1.599	.686	2.285	7	13
20-50	3,568,912	427	180	607	1.524	.624	2.166	5	12
50-100	353,158	794	342	1,136	.280	.121	.401	0.5	2
100-500	74,631	2,202	1,007	3,209	.164	.075	.239	0.1	1
500-1,000	1,795	10,232	7,924	18,156	.018	.014	.032	*	0.2
1,000 and over	655	30,501	43,320	73,821	.020	.028	.048	*	0.5
Totals	73,108,064				12.943	5.450	18.393	100	100

Note: Details may not add due to rounding.

percent of federal funds under a progressive system, but only 1.7 percent under a flat matching grant system. This result is to be expected since the higher income group gives larger amounts to charity than do the lower income groups, and a substantial number in the group give high percentages of their AGI to charity.

These same factors have corollary effects on the allocation of gifts by type of charitable groups. These effects are explored in Chapter IV. Finally, as noted before and as is set forth in greater detail in Chapter V, the flat matching grant technique offers a more simpler administrative device by which the federal shares can be delivered.

But at this juncture, from the standpoint of effects on donors, the choice between a progressive and a flat matching grant schedule appears to turn on two factors:

1. The progressive matching grant technique provides a more powerful incentive to private giving.

2. The flat matching grant system gives lower-income donors control over federal funds commensurate with their level of giving and hence may be seen to achieve greater dispersion of control over federal funds.

Special Problem of Appreciated Property

The discussion to this point has focused only on the charitable contribution made in the form of a cash donation. This approach, in addition to simplifying analysis, appears justified since cash contributions account for some 91 percent of the total charitable contributions.[104] Nonetheless, account must be taken of the fact that some donors utilize appreciated property to a significant extent, and that gifts of property represent substantial portions in the total gifts received by particular types of charitable organizations.

Under present tax rules, generally, the donor who gives appreciated property receives both a deduction for the contribution and an exemption from tax on the accrued gain.[105] The Tax Reform Act of 1969 took steps to deal with this tax problem where the gain would constitute ordinary income upon sale.[106] But ironically, reforms in the capital gain area just made the charitable deduction problem worse where capital assets are transferred. Prior to the 1969 act, the contribution of a capital asset with $100 of appreciation cost the Treasury $95 ($70 from the deduction, $25 in forgiven capital gain tax). But with the repeal of the alternative tax for gains above $50,000, the federal cost of a gift of the same asset to charity went to $105. When the potential impact of the minimum tax and maximum tax is added in, the cost to the Treasury can now rise to $115.90 to get the same $100 gift that cost only $95 before "tax reform."[107]

How should the proposed matching grant system treat charitable contributions of appreciated property? Three possible responses can be compared:

1. The full fair market value of property donated to charity could be treated as the amount contributed for purposes of determining the matching percentage. A gift of stock with $100 in appreciation would trigger the same federal matching share as a gift of $100 cash, thus correlating the match with present tax rules for gifts of appreciated property to publicly supported charities.

2. The federal matching grant rules could more closely correspond to present tax rules. The amount of the contribution would equal the fair market value of the property contributed, except in the situations specified in section 170(e). Thus, in the case of gifts of property which if sold would produce

ordinary income, the contribution would be treated as having a value equal to cost basis for purposes of determining the matching percentage. In the case of gifts of capital gain property of the type specified in section 170(e), the value of the gift would be treated as being equal to cost basis plus one half of the gain.

3. All noncash contributions could be treated as having a value equal to cost basis for purposes of determining the matching percentage.

Under either item 1 or 2, charitable institutions that rely on gifts of appreciated property would not suffer from any aggregate decrease in giving under the proposal simply because the gifts are in the form of property rather than cash. As noted in Chapter IV, the matching grant formula itself may produce some decrease in giving to institutions relying on large gifts from wealthy contributors. But adoption of either item 1 or 2 in the case of donations of appreciated property would prevent these institutions from suffering any additional loss because the contributions take the form of appreciated property. This result follows under item 2 because the institutions relying heavily on gifts of appreciated property are not generally within the types specified in present section 170(e).

On balance, adoption of the second response would appear preferable. This rule reflects the most recent congressional evaluation of the types of charitable institutions that should be relatively more favored by federal matching funds. In addition, it leaves the larger question of the proper treatment of transfers of appreciated property to charity to be resolved in the context of proposals dealing generally with donative transfers of appreciated property.[108]

The direct matching grant system, by itself, could prove attractive to those institutions that rely on gifts of property. Under the proposed system, not only could the institution receive the property, but it could also realize cash from the federal government's matching grant. Thus, for example, a gift of land to a conservation trust not only insures the preservation of the land, but would also generate cash for the organization with which to acquire additional open-space property.

With the repeal of the charitable deduction, we might expect an increased use of the bargain-sale technique. That is, donors might desire to sell the property for an amount sufficient to equal all (or a significant part) of the financial benefit no longer available through the charitable contributions deduction. The organizations would use their federal direct matching grants to effect the purchase element of the transaction.

An example can illustrate the probable response by donors of appreciated property. Suppose the donor (who is in the 50 percent tax bracket) wishes to donate stock to her university. The stock has a fair market value of $10,000 and a basis of $5,000. The donor is in the top matching grant bracket of 50 percent. An outright gift would provide the university with $10,000 in stock and $5,000 in cash from the government. But, by virtue of the repeal of the charitable contributions deduction, the donor will pay $5,000 more in income tax than at present. She is willing to have her net worth decrease by $2,500 as under present law, ($10,000 stock minus $7,500 tax benefits). Accordingly, she effects a bargain sale of the stock to the university for $5,000. Under present tax rules, the donor would make a gift of $5,000 and a sale for $5,000. The $5,000 basis would be allocated entirely to the sale portion of the transaction, resulting in no taxable gain.[109] The donor would thus have $5,000 in cash after the transaction and would have realized the same $2,500 reduction in net worth as under present law, that is, $10,000 in stock minus the sum of $2,500 in foregone tax on the gain plus $5,000 in cash.

Of course, the numbers will not work out so neatly for all donors. The bargain sale necessary to make a given donor "whole" (that is, in the same position as under present tax rules) depends on the donor's tax bracket, federal matching grant bracket, and the ratio of gain to fair market value for the asset donated. In some cases the federal matching grant share from the particular gift will be more than is required by the charity to effect a bargain purchase, in others less. On balance, however, adoption either of method 1 or 2 for gifts of appreciated property should enable charities that presently benefit from gifts of appreciated property to continue to do so.[110]

Conclusions as to Effect of Change on Donors

The study indicates that donors would respond favorably to the substitution of a direct matching grant system for the present tax deduction system. Donors would give at least as much to charity—in combined private and federal funds—as they do under the present system. In addition, either a progressive or a flat matching grant achieves significant improvements in (1), increased equity among donors and (2) more open and rational direction of federal funds to encourage private philanthropy. This is true of both gifts of cash and gifts of property. The choice between a progressive and flat matching grant mechanism is one between the greater incentive in the progressive match and greater dispersion of control over federal funds to lower-income donors under the flat match.

IV

EFFECTS OF CHANGE ON DONEES

Aggregate Effects on Charitable Organizations

As Professor Feldstein has observed:[111] "By selecting the appropriate rate for the matching grant, the government can induce the same aggregate contribution that would have been made if contributions were deductible. Since the economic evidence indicates that the price elasticity of giving is approximately minus one and does not differ significantly among income groups, the total cost in terms of foregone tax revenues is essentially independent of the method used to stimulate contributions. The change from the current system of deductions to a . . . matching grant would therefore require no change in tax rates. In principle, therefore, if the current deduction were replaced by a [matching grant], the worth-while activities of the charities would still be achieved, the taxes of high income individuals would rise and the taxes of lower income individuals would fall."

Thus, if the federal government shifted to a matching grant system that expended funds in the same amount as would be foregone through the charitable deduction, aggregate funds received by charity would be unchanged from the present system. Correspondingly, if the federal government increased its financial commitment, aggregate funds received by charity would likewise rise. For example, Professor Feldstein has estimated that a flat 43 percent matching grant in 1970 would have increased the government share from $3.6 billion to $5.9 billion. As expected, amounts received by all charitable organizations would have risen from $17.3 billion to an estimated $19.8 billion.[112]

Effects on Particular Types of Charitable Organizations

General

As the following data show, high-income individuals and low-income individuals do not give to the same charities. Thus a system that shifted some of the designation power over the same aggregate federal funds as at present from higher-income to lower-income individuals would allocate funds from the charities currently favored by the wealthy—institutions of higher learning, museums, and symphonies—to those selected by lower-income donors.

Tables 13 to 15 provide the most recent data with respect to the allocation of charitable giving by classes of recipients.[113]

As Table 13 indicates, lower-income donors give primarily to religion, the United Fund, and social welfare organizations, with over 75 percent of the contributions by the under-$15,000 AGI classes going to religion. The giving pattern shifts noticeably at the upper-income levels, especially as to those donors with incomes in excess of $50,000 per year. Although those wealthy donors still give a large percentage (over 50 percent) of their gifts to religion, the percentages of their total contributions that go to education and to the category including museums substantially exceeds that of lower-income donors. Thus, while those below $15,000 AGI give about 1 percent of their donations to education, the over-$50,000 group directs over 14 percent of its contributions to education. The $20,000-50,000 group displays similar contribution patterns, with some shift taking place from religion at the lower range to the category including museums and educational television at the upper range.

In aggregate terms, Table 15 shows that religion received over $9 billion from itemizers in 1972. While it is clear that education is the relatively more favored charity of the wealthy, it is important to observe that religion in 1972 received over $1.2 billion from the over-$50,000 group. This group, comprising less than 500,000 taxpayers, contributed almost as much to religion as did the 14.8 million itemizers with AGI's of $10,000 or less. Thus, while the percentages indicate that the wealthy favor education relatively more than lower-income persons, in total dollars contributed religion is heavily reliant on wealthy donors.

Table 15, however, does show that in 1972 over 65 percent of the $552 million received by education through the deduction mechanism came from donors in the over-$50,000 AGI class. By comparison, education received less than 5 percent of its contributions from the under-$15,000 donors.

Tables 13, 14, and 15 do not, however, reveal the entire picture. These data do not include contributions by donors who claim the standard deduction. An estimated $3.4 billion[114] was contributed to charity by these individuals in 1972. Most standard-deduction returns involved AGI's of less than $15,000. If giving patterns by the standard-deduction group followed those in Table 13, that is, about 75 percent to religion and only 0.7 percent to education, then the relative importance of high-bracket donors to educational institutions is emphasized even more.

Professor Feldstein has studied the impact on specific types of charitable organizations that would result from repeal of the present deduction.[115] His results are summarized in Table 16.

Professor Feldstein's study in Table 16 includes standard-deduction donors, and contributions of appreciated property are taken into account. Since, under Feldstein's analysis, price effects are most potent for high-income donors who are also the primary contributors to education, it is not surprising

Table 13

Percentage Distribution of Contributions on Returns with Itemized Deductions, 1972

Adjusted Gross Income Class	Religion	Health	Education	United Fund	Other Charitable[a]	Miscel-laneous[b]	Total
Under $5,000	75.4%	4.0%	0.7%	2.7%	7.6%	9.6%	100%
$5,000 to $9,999	75.2	2.8	1.1	2.2	9.5	9.2	100
$10,000 to $14,999	77.6	2.2	0.8	2.9	7.5	9.0	100
$15,000 to $19,999	74.5	2.2	1.3	4.0	8.9	9.1	100
$20,000 to $24,999	69.6	3.2	3.4	5.1	9.9	8.8	100
$25,000 to $29,999	64.3	3.7	3.2	5.7	11.9	11.2	100
$30,000 to $49,999	63.9	2.7	3.0	6.9	10.5	13.0	100
$50,000 and over	50.7	4.1	14.6	4.0	7.9	18.7	100
All classes	68.6	2.9	4.2	4.0	8.9	11.4	100

Office of the Secretary of the Treasury, Office of Tax Analysis — October 3, 1974

a. Includes several welfare groups, such as the Red Cross, Salvation Army, United Jewish Appeal, and the Catholic Welfare Fund.

b. Includes Boy Scouts, Girl Scouts, museums, libraries, educational television stations, and fraternal and veterans organizations.

Source: Statistics of Income, 1972, Individual Income Tax Returns and the 1972 Taxpayer Usage Sample.

Table 16

Average Amount of Itemized Deductions for Contributions by Type of Recipient, 1972

Adjusted Gross Income Class	Religion	Health	Education	United Fund	Other Charitable[a]	Miscellaneous[b]	Total
Under $5,000	$ 176	$ 9	$ 2	$ 6	$ 18	$ 22	$ 234
$5,000 to $9,999	213	8	3	6	27	26	284
$10,000 to $14,999	266	7	3	10	26	31	343
$15,000 to $19,999	316	9	6	17	38	39	424
$20,000 to $24,999	378	17	1[illegible]	28	54	48	543
$25,000 to $29,999	446	26	23	40	83	78	694
$30,000 to $49,999	660	28	31	71	108	134	1,032
$50,000 and over	2,174	177	627	173	337	803	4,291
All classes	$ 336	$ 14	$ 20	$ 20	$ 44	$ 56	$ 490

Office of the Secretary of the Treasury, Office of Tax Analysis October 3, 1974

a. Includes several welfare groups, such as the Red Cross, Salvation Army, United Jewish Appeal, and The Catholic Welfare Fund.
b. Includes Boy Scouts, Girl Scouts, museums, libraries, educational television stations, and fraternal and veterans organizations.

Source: Statistics of Income 1972, Individual Income Tax Returns and 1972 Taxpayer Usage Sample.

Note: Average contributions per return is calculated by dividing the aggregate amount of deductions by the total number of returns in the AGI class with itemized deductions.

Table 15

Aggregate Amount of Itemized Deductions for Contributions by Type of Recipient, 1972
(in millions of dollars)

Adjusted Gross Income Class	Religion		Health		Education		United Fund		Other Charitable		Miscellaneous		Total	
	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total	Amount Contributed	Percent of Total
Under $5,000	$ 257	2.8%	$ 14	3.6%	$ 3	.5%	$ 9	1.7%	$ 26	2.2%	$ 33	2.2%	$ 340	2.6%
$5,000 to $9,999	1,391	15.3	51	13.2	21	3.8	41	7.8	176	15.0	170	11.3	1,850	14.0
$10,000 to $14,999	2,115	23.3	59	15.3	22	4.0	80	15.2	206	17.5	244	16.2	2,727	20.6
$15,000 to $19,999	1,745	19.3	52	13.5	31	5.6	93	17.6	208	17.7	213	14.2	2,342	17.7
$20,000 to $24,999	978	10.8	44	11.4	48	8.7	72	13.6	139	11.8	124	8.3	1,406	10.6
$25,000 to $29,999	503	5.5	29	7.5	25	4.5	45	8.5	93	7.9	87	5.8	782	5.9
$30,000 to $49,999	817	9.0	35	9.1	39	7.1	88	16.7	134	11.4	166	11.0	1,279	9.7
$50,000 and over	1,258	13.9	102	26.4	363	65.8	100	18.9	195	16.6	465	30.9	2,482	18.8
Total	9,063	100%	386	100%	552	100%	528	100%	1,177	100%	1,503	100%	13,200	100%

Office of the Secretary of the Treasury, Office of Tax Analysis

October 3, 1974

Source: Statistics of Income 1972, Individual Income Tax Returns and 1972 Taxpayer Usage Sample.

Table 16

Summary of Gifts by Donee
(in billions of dollars)

		Tax Rates Unchanged	
	New Law	Old Law	Ratio
Religion	$ 8.158	$10.441	0.781
Education	0.355	0.679	0.523
Hospital	0.156	0.289	0.541
Health and welfare	1.819	2.499	0.728
Other	2.281	3.417	0.668
Total giving	$12.770	$17.324	0.737

Notes:
1. The deduction is eliminated.
2. For asset giving, gain value is 0.5.
3. Price elasticity -1.285, income elasticity .702.
4. All dollar amounts pertain to 1970.

Decreased gifts = $4.555 billion

Increased taxes = $3.521 billion

Ratio = 1.293 dollars of charity decrease per dollar of increased revenue

that repeal of the present charitable contributions deduction produces a bigger percentage reduction in receipts for education (46 percent) than for religion (22 percent) and social welfare organizations (27 percent), which are favored by lower-income individuals. But, as Table 15 indicated, religion would suffer the greatest volume reduction in giving, about $2.3 billion annually, compared with only $324 million for education.

The foregoing analysis, of course, assumes that the government simply repeals its present funding of the federal program for charitable organizations. The critical problem is to determine the impact that would be produced by simultaneous institution of a direct matching grant system.

Progressive Matching Grant

Table 17 sets forth in summary form an allocation of the private-federal contributions among charitable organizations that in 1970 could have been expected from implementation of a progressive direct matching grant system. The table employs a price elasticity of 1.0 and uses the income elasticities developed by Feldstein.[116] It is based on the matching grant schedule set forth at page 2418.

Tables 18 and 19 provide more detailed information[117] on the summary data contained in Table 17. Table 18 demonstrates for each donee category the estimated breakdown between the federal and private shares. In addition the table shows for each donee category the percent of total giving that is represented by the federal share, the percent of the total federal funds and of

Table 17

Gifts by Donee Category
(in billions of dollars)

Donee Category	Direct Matching Grant	Present Law
Religion	$11.403	$10.995
Education	.529	.688
Hospitals	.231	.293
Health and welfare	2.553	2.597
Other	3.275	3.549
Totals	$17.992	$18.122

total private funds received by each category, and the percent of combined private-federal contributions that would be received by each type of donee. Table 19 provides still further data by showing the private and federal shares for each type of donee by donor AGI class.

The above tables demonstrate two anticipated results. One, if the matching grant formula is established to provide the same federal revenue to charitable institutions as is presently expended through the income tax deduction, aggregate giving to charity will equal the amounts obtained under the present system. Two, while aggregate giving would remain the same, there is a reallocation of funds from charities that now rely on upper-income donors to those that are supported by low-income donors. Thus, religion gains somewhat while other categories lose to the same extent. This result is the expected product of a more democratized system.

But Table 18 does offer some useful data as to the extent to which policy makers should be concerned about this shift. Under the new system, federal support of all types of charitable organizations is remarkably even-handed. Thus, for all donee categories, the federal share comprises about 18-20 percent of total funds received by that category.

Some concern might be expected about the decline in receipts by education, especially higher education, if a direct matching grant system were adopted. The concern appears to be distinctly a minor one. In 1970, education received $688 million from individuals; this sum was almost one third of all funds received by education from donations from all sources in that year. Under the direct matching grant system, education would receive about $529 million. This represents a decline of somewhat more than 7 percent in giving from all donors.[118] Many universities each year experience greater swings than this by virtue of changes in market values of investment portfolios, inflation, and the like. Education receives only about 3 to 4 percent of all giving by individuals under either the deduction or the matching grant system. To permit a small decline in receipts by this one category to justify a rejection of the proposed system is to let the educational tail wag the philanthropic dog.

We have noted the elitist element in the present deduction system that weights distribution power so heavily to the wealthy. But, in addition, the wealthy do not favor higher education indiscriminately. In 1973-74, only 16

Table 18

Private-Federal Shares by Donee Category
(in billions of dollars)

Donee Category	Private Gifts	Federal Match	Total	Federal Share as Percent of Total	Percent of Total Federal Funds Received by Category	Percent of Total Private Funds Received	Percent of Total Combined Funds Received
Religion	$ 9.208	$2.186	$11.394	19%	62%	64%	64%
Education	.418	.105	.523	20	3	3	3
Hospitals	.194	.047	.241	20	1	1	1
Health and Welfare	2.092	.472	2.567	18	13	14	14
Other	2.656	.610	3.266	19	17	18	18
Totals	$14.454	$3.538	$17.992	100%	100%	100%	100%

Note: Details may not add due to rounding.

Table 19

Private-Federal Shares by Donee Category and Donor AGI Class
(in billions of dollars)

AGI Class	Religion			Education			Hospitals			Health and Welfare			Other		
	Private	Federal	Total	Private	Federal	Total	Private	Federal	Total	Private	Federal	Total	Private	Federal	Total
0-5	$2.069	$ .454	$ 2.523	$ .023	$ .005	$.028	$.023	$.005	$.028	$ .340	$.057	$ .397	$ .510	$.085	$ .595
5-10	2.865	.732	3.597	.051	.013	.064	.017	.005	.022	.581	.151	.732	.668	.172	.840
10-15	2.258	.534	2.792	.055	.013	.068	.022	.005	.027	.520	.109	.629	.520	.109	.629
15-20	1.023	.227	1.250	.061	.011	.072	.028	.005	.033	.276	.061	.337	.310	.066	.376
20-50	.846	.196	1.042	.118	.025	.143	.061	.014	.075	.275	.064	.339	.368	.085	.453
50-100	.108	.028	.136	.045	.012	.057	.020	.005	.025	.060	.015	.075	.109	.028	.137
100-500	.036	.013	.049	.048	.018	.066	.017	.006	.023	.033	.012	.044	.115	.042	.157
500-1,000	.002	.001	.003	.008	.004	.012	.003	.001	.004	.004	.002	.006	.021	.009	.030
1,000 and over	.001	.001	.002	.009	.004	.013	.003	.001	.004	.003	.001	.004	.035	.014	.049
Totals	$9.208	$2.186	$11.394	$ .418	$ .105	$.523	$.194	$.047	$.241	$2.092	$.472	$2.564	$2.656	$.610	$3.266

universities, mostly the wealthy private universities, received 50 percent of all funds contributed by individuals to higher education.[119] The argument to retain the allocation among charities that the present deduction system achieves is both an argument to permit the wealthy to continue to direct federal funds to their charities and to insure that the already wealthy universities—The Harvards, Yales, Columbias—do not see any of their funds shifted to other charitable activities. The critical question, even for the policy maker with a major concern for higher education, is thus whether the benefits achieved in terms of increased equity, effectiveness, pluralism and rationality are worth the "price" paid in shifting some funds from some universities to other charities.

And it must also be emphasized that adoption of the direct matching grant system does not necessarily require any decline in aggregate funds received by higher education. If Congress is concerned with the $159 reduction for funds for education, it can directly appropriate that amount to bring education back to its present level of funding.

It is important to note from Table 18 that religion would have received in 1970 an estimated 62 percent of all federal funds under a direct matching grant system. This figure may be relevant for the constitutional status of the system. By comparison, religion in 1970 received an estimated $1.7 billion, or 50 percent, of the federal funds expended through the deduction. A cautionary note should be sounded here. The category "religion" encompasses all activities conducted by religious organizations—education, social welfare, health, and so forth—not just sectarian activities.

Flat Matching Grant

The shift to a flat 43 percent flat matching grant system in 1970 would have increased federal expenditures by over 50 percent and would also have produced a significant shift in receipts by type of charitable organizations. As Table 20 indicates,[120] amounts received by religion would have increased by about $2.1 billion, or 20 percent. This increase is some $300 million less than the aggregate increase by all charities and represents about 88 percent of the increased federal funds for charitable organizations. On the other hand, receipts by education decline by $116 million or 17 percent.

Comparison of Progressive Matching Grant and Flat Matching Grant

A comparison of the effects on donees of adopting a progressive matching grant as opposed to a flat matching grant technique shows that the choice between the two systems, insofar as effects on donee organizations are concerned, largely reflects those that we observed in comparing the two systems with regard to their effects on donors.

Thus, Table 20 shows that a flat matching grant system allocates less funds to higher-income donors than the progressive matching grant schedule. Hence, religion would benefit relatively more from a flat matching grant schedule since it is the most favored charity of lower-income individuals. Conversely, education fares relatively better under a progressive matching system since the more potent incentive of the progressive match induces high-income donors to give larger percentages of their income to charities that they support. For example, even though the data in Table 20 reflect a 50 percent increase in federal funds for charity as compared with Table 17, education increased its receipts by only $34 million or 6 percent. A 50 percent increase in federal funding under a progressive matching grant system could be expected to produce significantly better results for education.

Table 20

Summary of Gifts by Donee
(in billions of dollars)

	Tax Rates Unchanged		
	New Law	Old Law	Ratio
Religion	$12.590	$10.441	1.206
Education	0.563	0.679	0.830
Hospital	0.248	0.289	0.858
Health and welfare	2.837	2.499	1.135
Other	3.542	3.417	1.037
Total Giving	$19.780	$17.324	1.142

Notes:
1. Credit as percent of gift, credit = 30 percent = 43 percent flat matching grant.
2. For asset giving, gain/value is 0.5.
3. Price elasticity -1.285, income elasticity .702.
4. All dollar amounts pertain to 1970.

Increased gifts = $2.456 billion

Decreased taxes = $2.106 billion

Ratio = 1.166 dollars of charity increase per dollar of decreased revenue.

V

ADMINISTRATION OF MATCHING GRANT SYSTEM

Definitional Problems

Progressive Matching Grant Method

Definition of income. (1) Inclusion of certain tax preference items. As discussed above, a progressive direct matching grant system is based on a measurement of effort, that is, the percent of total income donated. Ideally, "total income" for purposes of the matching grant program should conform to the economic definition of income.[121] It is unrealistic to expect to achieve an ideal definition of income for a program intended to benefit charity. But, at a minimum, "total income" should include adjusted gross income (AGI) plus tax-exempt interest, intangible drilling expenses, and items listed in I.R.C. §57. Since tax preference items predominate in high-bracket income, it is essential to use the broader definition of income when measuring relative effort in order to avoid the generation of the artificially high matching grants that would result if AGI were utilized in the matching grant formula.

The inclusion of the listed tax preference items in "total income" is quite possible to administer from the standpoint of the Internal Revenue Service.

From the viewpoint of the IRS, the "total income" concept presents no particular difficulties so long as it is confined to items that appear at some point on the tax return.[122] Only tax-exempt interest is not presently listed on income tax returns. The critical problem is enforcement. Tax-exempt interest could be part of the donation base at no additional cost, if enforcement of reported amounts is foregone and reliance is placed on donor honesty. On the other hand, if special funds are made available to the IRS for audit and enforcement activities, it is understood that "total income" need not be restricted to tax return items from the IRS viewpoint.

(2) Treatment of transfer payments. Since older people give a fairly substantial amount to charitable organizations (mainly churches) it must be determined whether or not to include transfer payments—especially social security benefits—in the definition of "total income." Social security payments constitute a major source of income for many elderly Americans. By the end of 1969, approximately 25.3 million people received benefits under old age, survivors, disability, and health insurance (OASDHI) totalling $26.8 billion.[123] Under the present tax system, such income is not taxable[124] and therefore is not annually reported to the IRS by the recipients. The problem is whether a matching grant system that does not include such payments in its definition of income will create unacceptable inequities since those who receive OASDHI payments could trigger larger matching grants than if these transfer payments were included in the income base.

Although the aged are not the only recipients of OASDHI benefits, transfer payments account for a large part of their income (48 percent).[125] A close look at the distribution of income of those aged 65 and over largely dispels equity concerns resulting from the exclusion of transfer payments from the income base. In 1967 there were an estimated 19.3 million persons aged 65 and over.[126] This number comprised 15.8 million "units"—married couples and unrelated individuals. According to a 1968 survey, 87 percent of the aged had incomes under $5,000 in 1967.[127] These income figures include OASDHI benefits as well as veterans' benefits, income from assets.[128] When broken down, nearly half (48 percent) of this income was accounted for by OASDHI and other public pensions.[129] When only OASDHI beneficiaries are included, the sample reduces to 12.4 million units, 90 percent of whom have incomes under $5,000.[130] OASDHI, veterans' benefits and other public assistance now make up approximately 54 percent of the income for these units.[131] There are therefore 11.2 million aged units in the $0-5,000 income bracket who receive OASDHI benefits. In comparison, there are 23.8 million families and unrelated individuals earning less than $5,000 per year.[132] Of these, less than half (11.2 million) are the above-defined aged units receiving OASDHI benefits.

Thus, if such benefits were to be excluded from the definition of the income base of the proposed matching grant system, the federal matching grants triggered will undoubtedly be higher than they should be. However, (a) since most of the aged (90 percent) fall into the $0-5,000 bracket where donations are small, and (b) since the aged make up less than half of the units in the $0-5,000 bracket, it is not at all clear that the inclusion of transfer payments in the income base would have a large enough effect to warrant the time and expense that would be incurred by such a requirement.

Nonetheless, the problem is essentially one of enforcement. Transfer payments could be required to be included by donors in "total income" for purposes of computing their federal matching grant. But, in the absence of extra funds for audit and enforcement, the IRS would be unable to monitor this requirement.

(3) Conclusion. Use of "income" as the base for a progressive matching grant system is appropriate despite certain definitional problems. These prob-

lems are not different from those experienced in the income tax. The existence of the minimum tax definitions solves most of the practical problems on the upper end of the income scale since the IRS now has the capability of handling these tax preference items. At the lower end of the income scale, efforts at passing a negative income tax (which would of necessity treat transfer payments as "income"), could, if successful, solve the practical problems for the matching grant system that are presently encountered with respect to including transfer payments in income.

Definition of the donor unit. The progressive direct matching grant proposal could create an incentive for intrafamily transfers of funds to take advantage of the increasing federal matching grant as the percent of income donated increases. Funds could be transferred to those family members with little or no income, whose subsequent contributions would represent a larger percentage of their income donated. The matching grant would thus increase without any real increase in effort on behalf of the donating family. To solve this problem the donor unit will be defined to include all persons in the marital unit, including those defined as dependents in section 152 of the Internal Revenue Code.

Under the progressive matching grant system, married couples might find an inducement to file separately, thereby triggering a larger matching grant. This problem is not peculiar to the proposed system, but rather is present in the income tax system where the amount of a deduction is determined by a percent of income. For example, medical expenses in excess of 3 percent of AGI can be deducted from the income base.[133] Under certain circumstances, this 3 percent qualifying floor could induce separate filing, as married couples seek to manipulate their reported incomes relative to their medical expenses. However, there is no clear-cut evidence that the incentive for filing separately has been a problem with section 213. Further, any manipulation of large amounts would require payment of a gift tax. Hence, this problem would appear to be minimal.

In the case of creation of trusts for the benefit of charity—either present or future—the direct matching grant will be available to the grantor and will be based on the present fair market value of the charitable interest. No further matching grant will be available to the trust upon actual distributions to charity. Similarly, in the case of a gift to a private charitable foundation, the match would be triggered at the time of the grant to the foundation; but no further match is triggered upon subsequent disbursements by the foundation. (In the case of existing trusts and foundations, the charitable contribution deduction has already been claimed, so that distributions by these entities should not be eligible for the direct matching grant program.)

Flat Matching Grant Method

A flat matching grant method would avoid the definitional problems discussed above. Since the federal match is a flat percentage of the dollar amount donated to (or received by) charity, there is no need to define income or the donor unit (the timing on matching gifts to charitable trusts or private foundations would have to be resolved as indicated above).

The fact that the flat matching grant method avoids the definitional problems renders it more simple than a progressive match method. The greater simplicity of the flat matching grant is one of its major attractions. This gain in simplicity must be balanced against the incentive arguments advanced for the progressive match method.

Bunched Contributions: Averaging Problems

Under a system of progressive matching grants based on the percentage of income donated, an individual donor could be tempted to defer his donations and give a large lump sum in one year, instead of giving in smaller, more uniform amounts annually. This tendency towards bunching could occur because the federal matching percentage increases as the percent of the donor's income given to charity increases. Thus, for a given dollar amount donated, the charities would receive more federal funds via a bunched gift than via equal yearly installments, assuming the donor's income does not increase dramatically.[134]

This inducement for bunched gifts does not, however, exist when the percentage of matched grants remains constant. Thus under a flat matching grant system, the dollar amount triggered is linearly related to the dollar amount donated.[135] Bunching is not induced since the dollar amount triggered is independent of the percent of income donated. Nonetheless because some may prefer a progressive matching grant schedule to a flat matching schedule on equity and incentive grounds, it is appropriate to examine ways of solving the bunching problem if a progressive matching schedule is adopted.

One solution to the bunching problem involves a compulsory averaging provision. Under such a system, the percentage matching grant would be determined according to the average of the percent of income donated during the, say, five previous years. As with the averaging provisions for the income tax, inequities caused by fluctuations are reduced through averaging over time. But unlike the income tax provisions, the matching grant averaging provisions must be compulsory. Otherwise, for the same total donations over two years between two individuals with the same income, the one who bunches his entire donation into a single year would trigger more federal funds. Here the progressive structure of the federal match encourages bunching by the donor and an optional averaging provision would do little to eliminate the resulting inequities.

An averaging provision would, however, require increased administrative costs due to the increased data compilation and computer storage requirements. If a linear average is chosen, then the longer the time span, the greater the storage requirements. For example, a *linear average* of the past five years' income would entail the addition of each year's income, which total is then divided by five. As the number of years increases, the data storage requirements also increase.

If, as has been proposed for the income tax system,[136] a five-year *weighted average* were used, the data storage requirements would be reduced to a single number. Under such a system, past incomes have a decreasing effect on the average, but their effect is never entirely eliminated.[137] The formula used for the averaging would be as follows:

(1) $\bar{C}_n = (1-W)\,C_n + W\bar{C}_{n-1}$

Where $\bar{C}_n$ is year n weighted average contribution

C_n is year n contribution

$\bar{C}_{n-1}$ is year n-1 weighted average contribution

W is the weighting coefficient

It is seen that the only piece of data carried forward is $\bar{C}_n$, thus making storage requirements minimal.[138]

Only in the initial phase of the proposed system would further computations be required. If a five-year weighted average is used, then $\bar{C}_0$ (the weighted average of the *initial* year of the matching grant system) would be computed as follows:

$$\bar{C}_0 = (1\text{-}W)\,C_0 + W(1\text{-}W)\,C_{-1} + W^2(1\text{-}W)\,C_{-2} \ldots + W^5\,(1\text{-}W)\,C_{-5}$$

This number $\bar{C}_0$ contains the weighted effects of the previous five years' contributions. $\bar{C}_0$ is the only number that need be stored, and the following year's weighted average contribution would be $\bar{C} = (1\text{-}W)\,C_1 + W\bar{C}_0$.

The initial $\bar{C}_0$, however, can only be calculated five years after the matching grant system has gone into effect, since the information required (gifts per year by each donor) would be unobtainable for years prior to introduction of the matching grant. One possible solution to this transition period would be to use a linear average for the first five years, and in year five the single value of the average contribution would be stored. The *weighted* average in year 6 could then be computed:

$$\bar{C}_6 = (1\text{-}W)\,C_6 + W\bar{C}_5$$

where $\bar{C}_5$ is a linear average and not the weighted average specified in the formula above.

For example, suppose that when the matching grant system goes into effect a donor with an annual income of $10,000 gives $200 to a charity for each of the first five years. In the sixth year he gives a bunched contribution of $1,000. The Internal Revenue Service would have on record the $200 figure, which is the linear average of his contributions for the first five years. It would then compute the weighted average for the sixth year contribution:

Let $W = .6$

$C_6 = 1000$

$\bar{C}_5 = 200$

Using the above formula:

$$\begin{aligned} \bar{C}_6 &= (1\text{-}W)\ 1000 + W\ (200) \\ &= .4\ (10000 + .6\ (200) \\ &= 400 + 120 \\ &= 520 \end{aligned}$$

The weighted average ($520) is 5.2 percent of income and triggers a 30 percent matching grant of $156.

Simple calculations can show that a larger sum would have been triggered to charities over these six years had this person split up his donation more consistently. If he had given $400 per year the first five years, his annual donation would have triggered a 25 percent matching grant of $100 per year. Over five years a total of $500 would have gone to charities in the form of a federal matching grant. Instead, $200 per year for five years triggered a 15 percent federal matching grant of $30 for a total of $150. Then in the sixth year, because of the weights imposed on the $1,000 gift, a $156 match went to charity for a total of $306 over six years.

It is clear in the above hypothetical situation that there is no advantage in bunching contributions. The above weights were arbitrarily chosen and are not necessarily those that should be used. The point, however, is this: if a weighted average were instituted, and appropriate weights were selected, donees would at best not benefit and might even lose when contributions were bunched. The incentive to bunch would then no longer exist.

If a progressive matching schedule is adopted, an averaging provision is necessary and must be adopted in order to discourage bunching. It should be noted, however, that this averaging provision acts mainly as a preventive, and the costs incurred by instituting such a provision should prove to be minimal. Furthermore, the averaging computations need not be performed every year for every filer. Instead, the averaging requirements could be limited to those instances where the percentage federal matching grant jumps by 10 or more percent. Such a limitation, along with the discouragement against bunching, should result in little use of the averaging computations.

The avoidance of the complexities of the averaging technique again make a flat matching grant method more attractive on administrative grounds than a progressive schedule. Again, the policy maker must compare gains in administrative simplicity with equity and incentive aspects of each matching technique.

Reporting of Donations

Progressive Matching Grant Method

Under the progressive matching grant proposal, charitable donees would receive their federal matching grant after the federal government is informed of the amount of the gift and the percentage of income donated by the donor to charity. The furnishing of this information by the donor to the government can be undertaken in one of two ways.

Under one system the donees could supply the requisite information to the Internal Revenue Service, listing the dollar amount received and the social security number of each donor. The Internal Revenue Service would then compile all the reported donations for each donor and the percentage of income given by each donor. The matching federal amount could then be credited to the account of the reporting donee. The advantage of such a system is that it places the prime responsibility for collecting and reporting information on the charitable donees. Since the donees are the principal parties who are financially interested in having the Internal Revenue Service receive this information, the system would be very reliable in distributing to charities all the federal funds due them. Nevertheless, serious problems arise in having the donees supply the information. An unacceptable burden might be placed on the Internal Revenue Service, due to the high computational and data storage costs. Other problems are created when the donors are not tax-return filers. Further, there could be a reluctance on the part of churches to file such information, especially since they are now excused from the information reporting requirement imposed on other charitable organizations.[139]

An alternative system, whereby the donors supply the gift information to the Internal Revenue Service, would involve less administrative costs. Under such a system, each donor would include with the income tax return (or by a separate schedule if he is not required to file a tax return) a listing of all of his contributions to qualified charitable organizations. The Internal Revenue Service could then compute the matching grant to each listed donee, and the data storage requirements would be limited to the number of eligible charitable organizations.[140]

Some problems do arise under such a system, however. First, information returns would have to be filed by all donors, whether or not they file a tax return. For the tax-return filers the donation information can be readily included with the Form 1040. However, for the Form 1040A filers and for the non-filers, a separate information form would have to be filled out and mailed by the donors.

A second problem could involve proper identification of the donees by the donors in their information returns. The Internal Revenue Service found that names were frequently reported inaccurately in the past when it was necessary to list organizations by name for purposes of the charitable contribution deduction.[141] Since, however, almost every eligible charitable organization presently has a taxpayer identification number, the donors should be required to list these donee taxpayer identification numbers in the information returns.[142] Given the financial interest of the donees in the matching grant, the donors will most likely receive ample information and encouragement from the donees regarding the proper taxpayer identification number.

Some additional costs would be incurred by the Internal Revenue Service in connection with the collection and disbursements of the matching grant funds. Estimates of the increased costs over the present system are not available.[143] Primarily, the expenses will be incurred as the result of the filing of extra schedules by those presently using Form 1040A[144] and by present non-filers.[145] (See page 2479 for a suggestion as to how these costs might be financed.)

Flat Matching Grant Method

A flat matching grant proposal is most easily effected if the donee organizations are responsible for reporting donations to the Internal Revenue Service. Since the federal matching grant is simply a flat percentage of donations, an organization would report its total contributions received for the year and receive from the Treasury a check for the applicable percentage of that amount.

The reporting procedures for the flat matching grant do appear significantly more simple and less expensive than would be involved in a progressive matching schedule. This simplicity is achieved primarily because the flat matching grant technique eliminates the necessity of correlating donations to a particular donor's income. On the other hand, organizations not now subject to reporting requirements—notably churches—would have to disclose information on donations received to obtain the federal funds.

Those who prefer a progressive matching grant on incentive grounds must decide whether the administrative advantages of the flat matching grant technique are of such magnitude that some compromise of the incentive issue is appropriate. Those who favor the flat matching grant technique even on equity grounds will find one additional attraction in the administrative advantages of this method.

Disbursement of Funds

Once the matching grant system is in effect—whether a progressive or flat percentage match is employed—each donee should receive one check annually after the Internal Revenue Service has made the calculation of its aggregate matching grant funds. For IRS scheduling purposes, it is essential that it not be required to send out donee checks during the period of time it is processing income tax returns. Presently, most charities receive a substantial amount of money at Christmastime. If federal checks for gifts made in the preceding year were to be disbursed between October and December the charities could plan on receiving an even larger amount at that time. The October-December period would also be acceptable to the Internal Revenue Service since most other income-related collections and refunds will have been handled by that time.[146]

Problems for donees with distributing checks according to the above schedule would appear to arise only during the first year of the new system. For example, if the matching grant system were to go into effect in January 1977, donees would have to wait until October-December 1978 to receive matching grants triggered in 1977. This problem would be partially alleviated in the first year if payments to charities were made on an estimated basis. Such an estimated payment system might even be suitable for the first few years, until charities are able to adjust to new patterns of giving and to the federal matching grant.

Audit

The integrity of a progressive matching grant system must be maintained through an audit of returns, similar to the procedure under the present deduction system. Under both systems there is always the problem of overreporting by donors, and presently more than one third of the costs incurred by the Internal Revenue Service is accredited to auditing of tax returns.[147] But the inducement for overreporting is not the same under both systems. Under the present deduction system, itemizers receive a direct financial benefit by overreporting their charitable contributions.[148] Under a progressive matching grant system, however, donors would not obtain a direct monetary benefit from the matching grant. The benefit of overreporting donations would go only to the donees, and hence donors have less of an incentive to overreport under the proposed matching grant system.

With a flat matching grant, donee organizations would perform the reporting function. While there thus would be an incentive for overreporting, normal IRS audit procedures with respect to charitable organizations should be sufficient to deal with this potential problem.

As mentioned above, auditing costs represent a sizable expense for the Internal Revenue Service. Funds for IRS processing and auditing costs under the proposed matching grant system could be obtained by earmarking part of the revenue increase resulting from repeal of the present deduction. For example, a 1 percent earmarking of the estimated $4.0 billion revenue gain in fiscal 1975 would produce $40 million for auditing and processing the new system. Such earmarking has the advantage of assuring needed funds in proportion to the volume of funds handled. As with any predetermined values, earmarking has the disadvantage that the percentage may be too large or too small, resulting in inefficiency. Nevertheless, if a flexible approach is adopted, the disadvantages of earmarking should be easily overshadowed by the advantage that the IRS would be assured needed revenues without having to sacrifice other audit or enforcement activities.

The audit and reporting requirements under the direct matching grant system are comparable to those employed under the present deduction system. Thus the integrity of the system can be maintained through donee reporting requirements similar to those presently in effect (I.R.C. §6033, Reg. §1.6033-1, Forms 990, 990A, etc.). Except for (a) churches, (b) organizations other than private foundations whose annual gross receipts are normally not more than $5,000, and (c) exclusively religious activities of any religious order, §6033 requires tax-exempt organizations to file an annual information return, stating specifically the items of gross income, receipts, and disbursements. According to the provisions set forth in §6033, every section 501 (c) (3) organization must also furnish information regarding the total of contributions and gifts received by it during the year, along with the names and addresses of all substantial contributors. Such donee requirements would remain under the proposed matching grant system.

Compliance

The effectiveness of the auditing program can be maintained only through compliance provisions, whereby sanctions are imposed for falsely claimed donations. Under a progressive matching grant system such penalties should primarily be imposed on the donor who is the reporting agent. An innocent donee should not suffer by being required to repay federal matching grant funds received in good faith. The federal matching grant would thus remain with the charitable organization, but the donor would be fined as follows: On the first level, the donor would be fined 100 percent of the federal matching grant triggered by the falsely claimed donation, plus 9 percent nondeductible interest. On the second level (amounting to civil fraud) the donor would be fined a penalty equal to twice the fines of the first level. This system of fines and penalties is similar to the taxes and penalties on self-dealing with private foundations [I.R.C. §§4941, 6684]. Under such a system, any person previously liable for the first level civil fine, or any person willfully and flagrantly liable for the first level civil fine becomes liable for an additional penalty. In addition to the above civil sanctions, criminal sanctions should also be established to deal with cases of criminal fraud. Such provisions would include both monetary fines and imprisonment. Donee organizations would be subject to sanctions if they, or their managers or principal donors, participated in fraudulent reporting of gifts by donors.

Under a flat matching grant system, while the donee organization would be responsible for accurate reporting of donations, the sanctions would be imposed on both the organization and the organization managers. The present rules dealing with private foundations, noted above, provide the appropriate model.

Transition Rules

The transition period of the matching grant system will require adjustments on the parts of the donor, the donee, and the IRS. Though many of the potential problems that might arise have been discussed above, carryovers of present charitable contributions deductions and the possibility that the system might deviate in practice from the results that are estimated must still be considered.

Treatment of Tax Deduction Carryovers

Presently, any donation that exceeds 50 percent of the donor's contribution base may be carried over and deducted over the next 5 years according to I.R.C. §170 (d) (1) (A). Once the matching grant system is instituted, the deductions that are carried forward could be treated as expenditures in the carryover year for purposes of computing the matching grant percentage. No deduction would, of course, be allowed for tax purposes.

However, a forceful argument could be made that the earlier excess contributions were made with the expectation that a deduction, not a matching grant, would result. An alternative solution, therefore, to the carryover problem would involve a dual system of matching grants and deductions for a limited period. Such a system could exist for at most only five years, since new tax carryovers would not be part of the matching grant system. Hence carryover deductions to the post-matching grant years would be allowed as tax deductions but would not qualify as donations in those years for purposes of the direct matching grant system.

Gradual Implementation of Matching Grant System

It may be desirable to phase-in over a 5- or 10-year period the proposed matching grant system. The present deduction system would be phased-out over the same time span. Such a transition period would permit charitable organizations to adjust gradually to the new system while still relying on the deduction system to some extent.

If a *progressive matching grant system* were adopted, the matching grant system could be phased in over a 10-year period under the following technique: Beginning with year one of the new system, 10 percent of a donor's gift would be directly matched and 90 percent would be allowable as a deduction. In each succeeding year an additional 10 percent of the donor's gift would come under the matching grant system. After 10 years, the deduction would be eliminated and the matching grant system would be fully in effect.

In the transition period, the donor would first calculate his net private gift and compute the federal matching grant percentage (FMG%) that would be applicable thereto if the new system were fully in effect. This FMG% would then be applied to the part of the gift that is matched directly as determined by the applicable transition percentage in the year (10 percent in year one, 20 percent in year two, and so forth). The balance of the gift would qualify for the charitable deduction. Thus, for example, in year one, 10 percent of the donor's gift would be matched directly and 90 percent would be allowable as a deduction.

Those claiming the standard deduction would simply have 10 percent of their donations matched in year one, 20 percent in year two, and so on.

The following examples illustrate the operation of the transition mechanism:

Example 1: Assume that married donors have an adjusted gross income of $68,000. They have personal expenses of $13,600 and claim $3,000 in personal exemptions. The personal expenses include $6,800 donated to charity. The donors are in the 50 percent marginal tax bracket.

Assume first that in year one of the new system the donors write checks to charity totalling $6,800. They would compute their FMG and their deduction as follows:

1. Compute FMG% as if system were fully in effect:
    Net private gift = $3,400 (50% x $6,800)
    Net private gift = 5% of income
    FMG % = 25%
    25% FMG x 10% of total gift ($680) = $170 FMG
    Allowable deduction = 90% x $6,800 = $6,120

2. Net result to charity:

Check from donor =		$6,800
FMG =		170
	Total	$6,970

3. Net result to donor

Net cost of deductible portion =	$3,060
Cost of nondeductible portion =	680
	$3,740

4. Net cost to government

Deduction =	$3,060
FMG =	170
	$3,230

Example 2: Assume the same facts as in Example 1, except that the donors' objective is to write out a check to charity which when added to the FMG in year one will result in a total of $6,800 being received by charity. The donor would write a check for $6,667.

1. Compute FMG% as if system were fully in effect:
   Net private gift = $3,333.50
   Net private gift = 4.9% of income
   FMG % = 20%
   20% FMG x 10% of total gift ($666.70) = $133.34
   Allowable deduction = 90% x $6,667 = $6,000.30

2. Net result to charity:

Check from donor =	$6,667.00
FMG =	133.34
	$6,800.34

3. Net result to donor:

Net cost of deductible portion =	$3,000.15
Cost of nondeductible portion =	666.70
	$3,666.85

4. Net result to government

Cost of deduction =	$3,000.15
FMG =	133.38
	$3,133.49

Example 3: Married donors have $15,000 AGI, claim the standard deduction, and make $600 charitable gift in year one of new system. The FMG% if system were completely in effect would be 20 percent since gift = 4 percent income.

Year one FMG = 20% x (10% x $600) = $12.

It should be emphasized that the above examples are intended simply to illustrate the mechanics of the transition rules given two possible donor responses. Obviously, the actual reaction of donors depends on the price effects of the deduction and the matching grant, respectively. The uncertainty involved in accurately predicting either price effect is one reason to adopt a fairly gradual phase-in of the new system.

If *flat matching grant* systems were adopted, a similar transition technique could be employed. Thus the direct grants to be received by the organizations could be phased-in ratably over 10 years and the donor's deduction eliminated over the same time span. For example, if a 40 percent flat matching grant were utilized, the donee would receive a 4 percent direct match in year one, 8 percent in year two, and so on. Correspondingly, the allowable deduction to donors would be reduced by 10 percent each year.

VI

A MATCHING GRANT IN LIEU OF ESTATE AND GIFT TAX DEDUCTIONS FOR CONTRIBUTIONS TO CHARITY

Introduction

The deduction for charitable contributions in the fedeal income tax law is not the only source of federal support to charities in the present tax system. The federal estate and gift taxes also make special provisions for transfers to charity, fundamentally by exempting such transfers from the basic transfer tax imposed on lifetime and death-time dispositions of property. As in the case of the charitable deduction in the income tax system, the special provisions concerning transfers to charities in the estate and gift tax systems are principally justified as a method of providing federal support to charitable institutions. It is thus appropriate to analyze these provisions, as was done previously in the case of the federal income tax charitable deduction, as a federal spending program in support of charities. Much of the analysis which follows parallels that previously undertaken with respect to the income tax deduction, and the arguments presented there in detail will be outlined here in more summary form. The following material will examine the present structure of the estate and gift tax system and the role the charitable deduction plays in that system, will then consider the arguments pro and con concerning the charitable deduction as a method of targeting government support to charities, and will finally analyze the proposed matching grant system which would replace the current charitable deduction.

History and Present Structure of the Estate and and Gift Tax Provisions

The forerunner of the present estate tax was first enacted in 1916 in response to governmental needs for additional tax revenues.[149] A transfer tax which falls only on transfers that take place at death may, however, be circumvented by lifetime transfers, and hence the estate tax provision was coupled with a gift tax provision in 1932 so that lifetime transfers could not circumvent the testamentary transfer tax system.[150] Conceptually, the estate tax and the gift tax function together as one system to tax all transfers that an individual makes during lifetime and at death.

The gross estate, which is the basic subject of the estate tax, is composed of the value of "all property to the extent of the decedent's interest in it at the time of his death."[151] In a similar fashion, the gift tax operates to tax lifetime transfers of any "property" by the transferor.[152]

In computing the estate tax liability, the gross estate is reduced by a number of deductions such as funeral expenses, expenses incident to the administration of the estate, losses during administration, various debts and enforceable claims against the decedent. The function of these deductions is to reduce the taxable estate to the net amount of property over which the decedent actually has power of disposition at his death. In addition, two other deductions are allowed, the so-called "marital deduction" which applies to property passing to the surviving spouse and the charitable deduction for the value of property transferred to or for the use of charitable institutions or the government. There is also a $60,000 exemption for all estates.

Taxable lifetime transfers under the gift tax are entitled to (1) a $3,000 annual exclusion per donee, that is, the first $3,000 of any gift to any donee is not subject to the transfer tax, (2) a cumulative $30,000 lifetime exemption, (3) a marital deduction, and (4) the charitable contributions deduction.

The charitable deduction was not included in the first estate tax law enacted in 1916, but was enacted two years later in the Revenue Act of 1918.[153] The original House version of the 1918 act contained no charitable deduction provision, but the Senate Finance Committee added a deduction for charitable bequests. The gift tax enacted in 1932, likewise, contained a deduction for transfers to charities which has been continued in the present statutory pattern.[154]

The rate structure in both the estate and gift taxes is progressive, with the estate tax rate a function of the size of the taxable estate and the gift tax rate dependent on the cumulative amount of taxable giving that the donor has undertaken. In the present system, the gift tax rates are approximately three fourths of those of the estate tax rates, thus imposing a lighter burden on lifetime as opposed to death-time transfers. In addition, the estate tax liability is not itself deductible from the taxable estate. In the gift tax, however, only the net amount of the gift transferred is subject to tax and the tax liability itself is not considered as part of the gift. This in effect amounts to a deduction of the gift tax from the basic amount of the gift, which also operates to favor lifetime as opposed to death-time transfers.

The Function of the Charitable Deduction in the Estate and Gift Tax System

As in the case of the income tax, the transfer tax system reflected in the current estate and gift tax provisions contains some provisions that are necessary to resolve *structural* problems in the tax and other provisions that are fundamentally extraneous to the definitional task and perform other functions. For example, in the estate tax the allowance of a deduction for funeral and administrative expenses of the estate is aimed at freeing from tax those transfers that are involved in arriving at the "net" amount of property over which the decedent has the power of disposition. The same is true for the deduction for obligations and claims against the estate. Deductions of this sort are directly analogous to the deduction of business expenses in an income tax system and are structural components whose function is to refine the subject of the tax.

The deduction for transfers to charity, however, stands on a different footing. It has nothing to do with the problem of determining what property is actually available for disposition, but rather exempts a certain class of dispositive transactions. The deduction must thus be justified in terms of purposes extraneous to the basic transfer tax system. The charitable deduction has from the beginning[156] been justified as providing an incentive or reward for the socially desirable activity of supporting charity. As such, it stands on the same footing as the charitable deduction in the income tax system. That is, it is fundamentally a method of channeling federal support to charities by encouraging or rewarding private donors to make lifetime and death-time transfers to charitable organizations. It remains to examine the advantages and disadvantages of this method of delivering federal funds as opposed to a program of direct matching grants.

Reasons For and Against Changes in the Present System

Tax Equity

The estate and gift tax charitable deductions have the same impact on equity in the transfer tax system as the income tax charitable deduction has in the income tax system. In the first place, the deductions offend the principle of horizontal equity that two taxpayers in the same situation should be treated in the same manner. If two estates are of equal size there is by definition an equal amount of property to be transferred, and under the transfer tax system the two estates should pay the same amount of tax. However, under the present system the two estates will have different tax liabilities if one estate makes a transfer to charity while the other transfers its property to noncharitable recipients.

As in the income tax system, the charitable contribution deduction also violates the principle of vertical equity in a progressive tax system by giving greater benefits to those taxable transfers in higher marginal brackets. Thus, for example, in the estate tax, a $50,000 net estate has a marginal tax rate of 25 percent while a $5 million net estate has the marginal rate of approximately 67 percent. The after-tax cost to the smaller estate of making a $10,000 transfer would be $7,500, while the same size transfer by the large estate would have an after-tax cost of only $3,300. The progressive rate structure reflects the social judgment as to how the tax burden should be allocated as a function of the size of the two estates. When the deduction is allowed, however, this effect is reversed, that is, the large estate receives a progressively greater benefit from the deduction than does the small estate. The same analysis is true of the gift tax. The present system of delivering the federal portion of charitable support by means of a tax deduction thus offends both horizontal and vertical equity in the transfer tax system.

Equity as an Expenditure Program

As in the case of the income tax system, it is appropriate to view the charitable deduction in the estate and gift tax structure as a program in which the taxpayer receiving the deduction is in effect allocating the matching federal financial support which the deduction provides. For example, a decedent with a net estate above $10 million who makes a donation to a charitable organization of $10,000 is in reality making a contribution from two different sources. The first source is his own funds in the amount of $2,300, the second is the federal government's $7,700, that is, the tax foregone which the government is willing to spend to induce the decedent to transfer $2,300 to charity. In comparison, a decedent with a net taxable estate of $10,000 who decided to transfer the whole $10,000 to a charitable organization will be making a gift from his own funds of $9,500 while the government share will be $500. Table 21 shows for selected estate sizes the present matching grant schedule that is produced by the charitable contributions deduction.[157]

To put the matter another way, if a decedent with an estate of less than $60,000 gives $1 of his own estate to charity, charity receives just the $1.00. But if a decedent with a $10-million estate gives $1.00 of his own funds to the same charity, the charity will receive $3.34.

Though the mechanics are somewhat different, the same analysis applies to the gift tax. The exclusion of gifts to charities is worth progressively more — and hence the donor's share of the gift is progressively less—depending on the amount of taxable transfers that the donor has previously made.

Table 21

Economic Estate	Private Bequest	Federal Matching Share
Under $60,000	$1.00	$ 0
$100,000	0.82	0.18
$500,000	0.68	0.32
$1,000,000	0.63	0.37
Over $10,000,000	0.23	0.77

This manner of structuring the private allocation of federal funds to charities is subject to the same objections on equity grounds as is the charitable deduction under the income tax. It gives no say in the allocation of federal funds to those estates under $60,000 which make charitable contributions but which pay no estate tax. It concentrates the power to allocate the federal share in the hands of wealthy decedents. The Internal Revenue Service undertook a special study of 1957 and 1959 estate tax returns which gives some indication of the concentration of federal spending power under the charitable deduction system in the larger estates. The special study found that in the 1957-1959 period over 40 percent of the total funds transferred to charity represented government contributions.[158]

The data have been updated on the basis of estate tax returns filed in 1970.[159] An analysis of these data shows that in 1970 a total of $2.13 billion was transferred at death to charity. Out of this figure, the government spent an estimated $1.07 billion—over 50 percent—as its share of the combined public and private support of charity. The private sector accounted for $1.06 billion.

The data for 1970 show that estates of total assets up to $100,000 transferred approximately $115 million to charities. Of this amount, an estimated $14 million represented the government share and the other $101 million the private transfers from the estates. This group represented about 34 percent of the total number of estates that made charitable transfers, and its net transfers were approximately 10 percent of the total net transfers. Under the deduction system, however, these estates were allowed to control the disposition of only 1 percent of the total amount of government funds spent.

The second group, those estates with assets ranging from $100,000 to $1 million, transferred $559 million to charities. Of this amount, the government subsidy was an estimated $150 million and the net transfers from the estates were $409 million. This group represented 61 percent of the total number of estates making transfers, and the amount of net transfers it made represented 42 percent of the total net transfers. This group, however, was allowed to control the disposition of only 14 percent of the government share.

The third group, representing those estates with total assets over $1 million, made charitable contributions of $1.42 billion, of which an estimated $908 million represented the government share and $511 million the net transfers from the estate. The number of estates represented only 5.7 percent of all estates, made only 47 percent of the total net transfers, yet controlled 85 percent of the total amount of the government subsidies spent through the deduction system.

This allocation of federal spending power is inequitable for several reasons. In the first place, it obviously concentrates the spending power in wealthy estates and thus undercuts the fundamental argument in favor of the charitable deduction based on the need for a pluralistic approach to the solution of social problems. Very little pluralism is obtained if large estates control virtually all of the governmental spending. Second, from a purely equitable point of view it seems wrong that the amount of governmental spending that a taxpayer is entitled to control increases as a function of his tax bracket even though his contribution in either absolute or relative terms remains the same.

The above analysis shows the inequity of the spending program within the group of those transferors who qualify for the program by transferring estates in excess of $60,000. It must be remembered, however, that this group encompasses only about 7 percent of all decedents. Thus, employing the estate tax deduction as the means of encouraging testamentary transfers automatically eliminates 93 percent of those who might make bequests to charity. Thus, the inequities noted above are inequities within an already highly elite group. One can ask whether a program that gives the wealthiest 7 percent of decedents the right to control annually $1 billion of federal funds has any claim to legitimacy at all in a democratic society.

Rationality of Appropriations Process

The process of appropriating federal funds for charity by tax deductions is as irrational in the estate and gift tax context as in the income tax system. Tax changes in the estate and gift tax laws, totally unrelated to the charitable contributions deduction, can unknowingly and unintentionally alter the amount of federal funding for this program.

Efficiency of the Estate Tax Deduction for Charitable Bequests

The question whether the deduction for charitable bequests is an efficient method of providing federal aid to philanthropic organizations has been the subject of very little study by economists.[160]

Professor Michael Boskin undertook for the Filer Commission the most extensive study of this issue to date.[161] Professor Boskin reached the conclusion that the deduction was efficient in the sense that the full amount of the federal revenue loss goes to charity. His study produced somewhat surprising price elasticities: Over 3.0 for small estates in tax brackets less than 20 percent (taxable estates under $50,000); about 1.7 for medium-sized estates in the 20-40 percent tax brackets (taxable estates ranging from almost $50,000 to about $1.5 million); and less than 0.7 for very large estates (over $1.5 million taxable estates). Wealth elasticities predictably showed an inverse pattern, ranging from 1.23 for over-$1 million estates and declining to 0.24 for estates under $250,000.[162]

Boskin's estimates thus indicate a net loss to charity of the full amount of the federal revenue (about $940 million under his estimate) if the deduction were repealed *and no other federal program to encourage testamentary giving were implemented.* The important question, then, is whether we can develop a substitute program that is at least as efficient as the tax deduction and mitigates its inequity and irrationality as a spending program.

Progressive Matching Grant

The mechanics of the matching grant are simple. A person will name a certain charitable organization to be the recipient of a certain amount of his estate. There will, of course, be no deduction taken for this bequest on his estate tax return; instead the government will match the decedent's contribution to the designated charity according to the following schedule.[163]

Percent of Total Estate Donated	*Matching Federal Grant as Percent of Donation*
0-5%	8.3%
5-10	16.6
10-15	24.9
15-20	33.2
20-25	41.5
25-30	49.8
30-35	58.1
35-40	66.4
40-45	74.7
45-50	83.0

The foregoing schedule assumes that the government would spend the same revenue under the testamentary direct matching grant system as it presently does under the estate tax deduction system. Price and wealth elasticities utilized to produce the schedule were those developed by Professor Boskin. The above schedule at 1970 levels would have produced about the same $2 billion for charity that it received from bequests in that year. Of this amount approximately $1.2 billion is net private giving, and the balance comes from the matching federal funds.

The "percent of total estate donated" simply refers to the ratio of the total amount of charitable bequests over the donation base. The donation base will be defined by starting with adjusted gross estate as calculated in the estate tax form (Form 706, p. 3, item 10). The adjusted gross estate is calculated prior to the marital deduction, and it also includes the first $60,000 that is taxed at a zero rate. The $60,000 certainly must be included in the donation base in order to allow a decedent whose net estate is below this figure the right to trigger a federal match. The question of whether the marital deduction should be included depends upon one's view of this deduction. If it is regarded as an exempt "transfer," then the amount of the deduction should be included in the donation base so that a married decedent whose pre-marital deduction estate is the same size as an unmarried decedent's estate would not be able to trigger more of a government match than the unmarried decedent simply because he was married. On the other hand, if one adopts the view that the marital deduction is designed to correspond to the community property concept, then there is no "transfer" by the decedent and the amount of the marital deduction should be excluded from the donation base.

Administratively, the progressive matching grant should not pose serious problems. The decedent would list the charities to which he wanted to make bequests, as he must now do in his will. When he died, his estate tax return would be filed as it is now, showing the amount of funds that were transferred to particular charities. The only difference would be that these funds would not be subtracted from the estate before calculating the amount of tax due.

The executor of the estate would calculate the amount of the matching grant funds by taking the adjusted gross estate figure, which must be calculated in any event, as the donation base and then adding together the total amount of the bequests and taking the percentage of the two. If the decedent left funds to more than one charity, the executor would calculate the portion of the matching grant to be credited to the individual charities by using the ratio of the amount of the bequests to a particular bequest and applying this to the total amount of matching grant funds. The estate tax return would be sent to the Internal Revenue Service, as it is now. It would have account numbers for each charity, and would simply credit the account of the recipient charity for the amount of the federal matching grant. Then at the end of the year the Treasury would send a check to the charity for the total amount that had been credited to it during the year.[164]

Flat Matching Grant

As in the case of the lifetime matching grant system, it would be possible to employ a flat matching grant mechanism rather than a progressive matching grant schedule. Thus, for example, all testamentary gifts to charity could be matched in an amount equal to 30 percent of the gifts. The exact percent used would be determined by revenue constraints.

A flat matching grant system would be more simple as an administrative matter. Each year charities that receive bequests could report the amount to the Treasury and receive the appropriate matching funds. No returns would thus have to be filed by small estates.

The bases for choosing between a flat and a progressive structure for a testamentary matching grant system are the same as for the lifetime system and will not be repeated here.

Gift Tax Aspects

The current transfer tax on gifts contains an exception for lifetime charitable giving. In order to parallel the elimination of the estate tax charitable deduction, the gift tax charitable deduction under the matching grant proposal would likewise be eliminated. However, no additional matching grant for lifetime giving would be enacted; the matching grant incentive for lifetime giving would be contained in the income matching grant system. Thus all lifetime transfers would trigger a matching grant under the income matching grant system, while death-time transfers would be matched by the estate matching grant system. While the introduction of a gift tax on lifetime transfers to charity would put those transfers in a relatively disadvantageous position in relation to the current deduction system, this could be offset by the level of the matching grant in the lifetime matching grant system.

Effects of Introduction of the Matching Grant Proposal

Equity Aspects

The introduction of a matching grant system to replace the current charitable deduction in the estate and gift tax area would substantially alleviate the equity problems inherent in the present system. Under the proposal, all transferors and not simply those whose wealth is sufficient to incur an estate tax would have a voice in the process of allocating federal funds. The dispersal of control over the federal monies would help reduce the undue impact that the preferences of wealthy transferors currently have on the allocation process.

Impact on Donors and Donees

The paucity of data concerning testamentary transfers and the effects of taxes thereon makes it impossible at this time to do more than provide rough estimates of the impact of a change from the present deduction system to a direct matching grant method.

In the aggregate, testamentary giving to charity should remain constant if the matching grant formula selected produces the same revenue loss as under the deduction. This general conclusion assumes a price elasticity of about 1.0 for the deduction and the matching grant.

However, on the donee side there would be greater relative control of federal funds by smaller estates (and by estates making charitable transfers which incur no tax liability) than is the case at present. This change is not very dramatic if nontaxable estates in fact give very little to charity, since it contemplates a shift in power only within the wealthiest 7 percent of estates. Nonetheless, as the prior discussion has shown, the extremely wealthy do control a disproportionate amount of the federal funds relative to their net private giving so that the change represents an improvement in equity while providing a potent incentive for testamentary charitable bequests.

It is equally difficult to be precise about effects of the change on donee organizations. This difficulty arises because the data available show the bulk of charitable bequests going to "other charitable" organizations. But it does seem clear that the shift in power from the wealthiest to somewhat less wealthy testators would not produce any dramatic shifts in receipts by certain types of organizations. For example, in 1961 educational, scientific, and literary organizations received $16 million in bequests from estates under $300,000 and $24 million from estates over $10 million.[165] Obviously, nothing very dramatic is going to occur for education if some portion of the $24 million is shifted from education to, say, religion (which is more favored by estates under $300,000).

The type of charitable institution that might be affected by the change is the private foundation. For the over-$10-million estate group, in 1961, some 92.2 percent of charitable giving went to "other charitable" organizations. This represented almost $297 million of the $327 million given by the wealthiest group in that year. It seems fair to assume that this "charitable" giving in fact represents giving to the testator's private foundation. By contrast, the "other" category represents only 62 percent of charitable giving by estates under $300,000.[166] Hence a shift of power over federal funds from the super wealthy to the merely wealthy might cause a fairly significant shift in funds from private foundations to public charitable organizations.

It is apparent that considerable study remains to determine the precise effects on donors and donees of both the present deduction system and a direct matching grant system.

As to other effects, as in the case of the income matching grant system, the conversion of the estate tax deduction into a matching grant program would involve no greater governmental control or supervision over the charity than the current system. In addition, it would free the charities from their current dependence on the vagaries of the estate and gift tax law to determine the amount of the federal support. This is especially important in the estate and gift tax area where substantial revision of the laws has recently been made and further changes are currently under consideration which could have substantial impact on the amount of federal funds allocated to charities under a deduction system.[167] (See also, the discussion in Chapter II, page 2431.)

Special Problems in the Estate and Gift Tax Matching Grant System

Relative Incentive for Lifetime versus Death-Time Giving

Under the present transfer tax structure there is decided incentive for noncharitable lifetime as opposed to death-time transfers generally. The rates for lifetime transfers are lower, transfers during life enable the estate tax rates to start again at zero on the property remaining at death, and under the gift tax there is no tax on the amount of the gift tax itself, that is, the gift tax is in effect a deduction from the amount of the taxable gift. But all of these considerations operate in reverse in the case of charitable giving. There the current system encourages the postponement of charitable giving in order to take the charitable deduction against the estate tax, where the tax burden is higher, rather than against the gift tax. However, lifetime gifts under the current system entitle the transferor to an income tax deduction which would be unavailable if the charitable giving was postponed until death. Thus, there is a relatively complex interaction of pressures for lifetime or death-time giving depending on the tax situation of the particular taxpayer and the relative importance of his income and accumulated wealth.

The same situation would exist under the matching grant system. For some donors, a lifetime transfer would result in a greater match because of the relative significance of the gift in relation to income; for others, the postponement of the gift until death in the form of a charitable bequest would trigger a larger matching grant. The interaction of the provisions in the current system is largely a matter of chance; if it is desired to establish a policy favoring either lifetime or death-time giving, appropriate adjustment in the matching-grant formula could achieve this result somewhat more rationally.

Treatment of Transfers Subject to Both the Gift and the Estate Tax

Under present law certain transfers may be subject to both the gift tax when made and the estate tax when the donor dies. These include so-called "split-interest" gifts where the donor retains some ownership rights in the property[168] and "gifts in contemplation of death"[169] which are made within three years of the decedent's death. Under the present system the gifts are subject to a gift tax which is then allowed as a credit against the estate tax when the property is included in the estate.[170] Such transfers raise no problems under the current deduction system since transfers to charity in either case are not taxable.

However, under the matching grant system such transfers would be taxable, and the question is how the matching grant system should operate in these cases. This structural problem would seem best resolved by giving a lifetime matching grant in the amount of the original charitable gift. The gift tax would be due on the gift, and when the property was again included in the estate a credit for the gift tax would be allowed as under the present system. The inclusion of the property in the estate would trigger no additional matching grant under the estate matching grant system; the original transfer would be the only "match triggering" event and would result in a matching grant under the lifetime matching grant system.

VII

FEDERAL FINANCIAL AID TO CHARITY: CONSTITUTIONAL ISSUES

Introduction

A system of direct federal matching grants to charity to replace the present income, estate, and gift tax deductions for contributions to charity by individual donors will involve payments of federal funds to religious organizations. The proposed system would match donations by individuals to those organizations to which contributions presently qualify for the charitable contributions deduction. Such organizations include "a church or a convention or association of churches."[171] Charitable contributions include gifts to a "corporation, trust or community chest, fund or foundation . . . organized and operated exclusively for religious . . . purposes . . . ," which meet certain prescribed tests.[172]

The question thus arises: Can the federal government under the First Amendment provide financial aid to charitable organizations generally if the definition of charitable organization embraces churches and other religious organizations?

A definitive answer to this question cannot be given since the United States Supreme Court has never had occasion to answer it directly. The Court has with some frequency, however, been called upon to decide cases involving governmental aid to religion. This part will examine the historical background of the First Amendment, the development of the standards utilized by the Supreme Court in testing the constitutionality of programs that provide governmental financial assistance to religion, and the application of those standards to both the present tax deductions for contributions to charity and the proposed direct matching grant system.

Although the matter is not free from doubt, it is concluded that the First Amendment does not bar federal financial aid to charities, including churches and other religious organizations, regardless of whether that aid is provided through the present system of tax deductions or through a direct matching grant system modelled on the tax deductions.

Historical Background

The first clauses of the First Amendment of the Bill of Rights state: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." It is helpful to examine briefly the historical context in which these terse clauses were developed to ascertain the intent of the framers of the amendment.

The language of the clauses in their brevity and absolute tone has caused considerable debate among legal scholars as to the actual intentions of its authors. Chief Justice Burger has written: "The Establishment and Free Exercise Clauses of the First Amendment are not the most precisely drawn portions of the Constitution."[173]

At the time of the adoption of the First Amendment, established churches were present in several states, Massachusetts maintaining The Congregational Church as the state church until 1833.[174] The amendment was enacted to apply only to Congress in an era in which state governments were possessed of relatively superior power.[175] Not until the passage of the Fourteenth Amendment in 1868 was there a basis for the restriction of states in religious matters.[176]

The interpretation of the origin of the First Amendment's religion clauses has ranged between two polar positions. At the most restrictive extreme is the position of Justice Black, who relied on Thomas Jefferson's "Wall of Separation."[177] On the other hand, noted constitutional scholars such as Professors Mark DeWolfe Howe[178] and Wilber Katz[179] have taken more flexible positions.

The classic "Wall of Separation" argument, as espoused by Jefferson and Madison, has been widely cited as holding that the Establishment Clause is to be read as an absolute prohibition to any involvement in religious matters by the federal government.[180] Professor Howe, among other legal scholars,[181] argued, however, that the Jeffersonian/Madison position was not the basic philosophical position of the founding Fathers. In his view, the "Wall of Separation" was a popular metaphor in the eighteenth century, used not only by Jefferson, but also by religious leaders such as Roger Williams of Rhode Island, who employed the phrase in quite a different sense.[182] Jefferson saw the need to guard against church domination of the federal government. Williams, on the other hand, remembering his own forced exile from Puritan Massachusetts, dreaded the involvement of government in church matters as a source of "worldly corruption." This latter view was also supported by Lord Baltimore in Maryland and William Penn in Pennsylvania. The distinction between the two principles reflects a predominant concern with politics on the part of Jefferson and with theology on the part of Williams. Therefore, Professor Howe argued that the Supreme Court in accepting the Jeffersonian position in *Everson* ignored the historical fact that religious skepticism over government interference with the church underlies the rule of separation, just as much as political fears of church involvement in government.[183]

Another scholar, Professor Katz, has suggested that the First Amendment prohibition against enactment of laws "respecting the establishment of religion" was intended to insure that the federal government would not interfere with existing state established churches.[184] In his book, *Religion and the American Constitution*, Professor Katz traces the evolution of the establishment clause. James Madison initially proposed to the House a religion amendment that provided "nor shall any national religion be established."[185] The House substituted the contrasting language of the New Hampshire proposal: "Congress shall make no laws touching religion."[186] The final House version submitted to the Senate was more ambiguous and read as a prohibition of "laws establishing religion."[187] After debating several proposals, the Senate adopted a similar proposal that forbade any "law establishing articles of faith or a mode of worship."[188] The language of the amendment as we know it was the result of the joint conference committee. From this legislative history, Professor Katz concluded that Congress in enacting the Establishment Clause sought to "protect from Congressional interference the varying state policies of church establishment,"[189] a policy consistent with general principles of federalism.

The Supreme Court, although it has from time to time made bows to the Jeffersonian position,[190] appears now to have firmly accepted the more flexible view. Thus, Justice Powell, writing for the majority in *Committee for Public Education and Religious Liberty* v. *Nyquist*,[191] stated:

> [T]his nation's history has not been one of entirely sanitized separation between Church and State. It has never been thought either possible nor desirable to enforce a regime of total separation, and as a consequence cases arising under these Clauses have presented some of the most perplexing questions to come before this Court.[192]

Similarly, Chief Justice Burger, in *Lemon v. Kurtzman,*[193] stated that the line of separation, "far from being a 'wall' is a blurred, indistinct, and variable barrier depending on all the circumstances of a particular relationship."[194]

Never in the nation's history has there been the total separation of church and state envisioned by Jefferson. The Northwest Ordinance enacted by the Continental Congress to systematically develop and incorporate new territory into the Union stated in its purpose clause:

> Religion, morality, and knowledge, being necessary to good government and the happiness of mankind, schools and the means of education shall forever be encouraged.[195]

The legislative history of that act illustrates the vacillating position of Congress with regard to religion. The original committee report recommended that two plots in each township be reserved, one "for the support of religion" and one for educational purposes.[196] The proposal was amended to eliminate the grant for religion, but three months later a report was adopted by Congress, presented by a committee whose membership included Madison, authorizing a lot "to be given perpetually for the purposes of religion."[197] A guarantee of religious freedom was also included.

Additionally, as noted by Justice Douglas in *Zorach* v. *Clauson*[198] and Justice Reed in *McCollum* v. *Board of Education,*[199] there are many other examples of "the government's recognition of the religious interests of its people and the accomodation of governmental policy to further this interest."[200] To note a few: (1) The use of chaplains to open sessions of Congress; (2) the commissioning of chaplains in the Armed Forces; (3) the granting of draft exemptions to theology students; (4) the provision of subsidies to church hospitals; and (5) the furnishing of police and fire protection to church property. Congress has provided that in the District of Columbia free water be given to churches and charities and to those schools that are charitable institutions.[201] Further, as part of the GI Bill of Rights there has been a direct expenditure of federal monies to train persons for the ministry in their chosen sect.[202] The Supreme Court has, since 1815, permitted religious organizations to have the privilege of incorporation.[203]

In light of this history, Professor Howe's charge that the advocates of the "Jeffersonian" strict construction theory fortify their position with a "Maginot line of spurious history,"[204] has considerable force.

The Supreme Court's Tests in First Amendment Religion Cases

In an early effort to outline the applicable constitutional standard to apply in First Amendment religion cases, Justice Black in *Everson* v. *Board of Education* recalled the Jeffersonian philosophy of "a wall between church and state" and articulated the constitutional mandates of the Establishment Clause as follows:

> The First Amendment has erected a wall between church and state. That wall must be kept high and impregnable. We could not approve the slightest breach.[205]

Despite the awesome finality of this pronouncement, Justice Black nonetheless concluded for the majority that the New Jersey legislature was constitutionally permitted to reimburse parents for bus fares paid for transporting their children to sectarian schools under a statute that authorized reimbursement for bus fares of school children generally, whether to public or to nonprofit private schools. The key factor in the majority's view appeared to be that the New Jersey legislation "does no more than provide a *general program* to help parents get their children, regardless of their religion, safely and expeditiously to and from accredited schools [emphasis added]."[206]

The *Everson* test was applied in *McCollum* v. *Board of Education*[207] (religious instruction of public-school students in public schools held invalid), *Zorach* v. *Clauson*[208] (religious instruction of public-school students under a released-time program held valid), *McGowan* v. *Maryland*[209] (state's Sunday closing law served secular purpose and was valid), *Torcaso* v. *Watkins*[210] (religious test for public office held invalid), and *Engel* v. *Vitale*[211] (nondenominational daily prayer in public schools held invalid).

It was not until *School District* v. *Schempp*[212] that the Supreme Court substantially added to the *Everson* test. In *Schempp,* the Court held that the Establishment Clause precluded the recitation of the Lord's Prayer in public schools even if those students who did not wish to participate were excused from attending the exercise. The *Everson* test was reformulated by the Court in the following terms:

> The test may be stated as follows: What are the purpose and primary effect of the enactment? If either is the advancement of inhibition of religion then enactment exceeds the scope of legislative power as circumscribed by the Constitution. That is to say that to withstand the strictures of the Establishment Clause there must be a secular legislative purpose and a primary effect that neither advances nor inhibits religion.[213]

This "primary purpose and effect test" was reiterated in *Sherbert* v. *Verner*[214] (disqualification of a Seventh-Day Adventist for unemployment compensation benefits for refusal to work on Saturday, held invalid), and was applied in *Board of Education* v. *Allen*[215] (New York's Education Law requiring local school authorities to lend secular textbooks free of charge to all students in both public and private schools held valid), and *Epperson* v. *Arkansas*[216] (Arkansas statute prohibiting the teaching of evolution in public schools held invalid).

In 1970 the Supreme Court extended the "primary purpose and effect" test. The Court held in *Walz* v. *Tax Commission*[217] that local property tax exemptions accorded to all educational and charitable nonprofit organizations, including exemptions for property used exclusively for church purposes, were constitutional. Chief Justice Burger expanded the *Schempp* test to prohibit "excessive entanglement" of government with religion.[218] The significance of the tax aspects of the *Walz* decision are discussed in the section below. Here its importance is that it added a new dimension to the constitutional standard to be applied in Establishment Clause cases, whether they involved tax provisions or direct financial aid. Thus, following *Walz,* the Court decided *Robinson* v. *DiCenso*[219] (Rhode Island 1969 Salary Supplement Act providing for a 15 percent salary supplement to be paid to nonpublic school teachers of secular subjects held invalid), *Lemon* v. *Kurtzman*[220] (1968 Pennsylvania Act authorizing the reimbursement by the state of nonpublic schools for the costs of teachers' salaries, textbooks and materials in secular subjects, held invalid) and *Tilton* v. *Richardson*[221] (provision in Higher Education Facilities Act of 1963 for federal construction grants for college and university facilities, including sectarian institutions so long as for secular purposes, held valid).

Lemon v. *Kurtzman* combined the *Walz* test and the previous First Amendment decisions to supply the "three pronged test"[222] of the Establishment Clause:

> First, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion . . . ; finally, the statute must not foster an excessive government entanglement with religion. . .[223]

The entanglement test requires that the courts "examine the character and purposes of the institutions that are benefited, the nature of the aid that the State provides, and the resulting relationship between the government and the religious authority."[224]

Beginning on page 2503, we will examine the application by the courts of the above tests in subsequent First Amendment cases for the light they throw on the constitutional issues raised by both the proposed direct matching grant system and the current system of income tax deductions for charitable contributions. It is appropriate first, however, to consider the preliminary question of whether different constitutional questions are involved if one is considering a program of federal financial aid effected through the tax system as compared with one effected through a direct payment system.

Tax Expenditures versus Direct Expenditures: Are the Constitutional Tests the Same?

Functional Equivalence

Before applying the Supreme Court tests developed above to the proposed matching grant system, it is appropriate to examine the question whether governmental financial aid provided through special tax benefits stands on any different constitutional ground than financial aid effected through direct expenditure programs. More specifically, the question may be asked, would the special tax deduction for charitable contributions[225] be upheld but a direct grant program modelled on the tax deduction be struck down?

Language by Chief Justice Burger in *Walz* v. *Tax Commission*[226] suggested that the Court might treat tax benefits differently as an economic matter than direct aid programs. In sustaining the constitutionality of a local property tax exemption provision that included property owned by religious institutions, Chief Justice Burger stated:

> Granting tax exemptions to churches necessarily operates to afford an indirect economic benefit and also gives rise to some, but yet a lesser, involvement than taxing them. In analyzing either alternative the questions are whether the involvement is excessive, and whether it is a continuing one calling for official and continuing surveillance leading to an impermissible degree of entanglement. Obviously a direct money subsidy would be a relationship pregnant with involvement and, as with most governmental grant programs, could encompass sustained and detailed administrative relationships for enforcement of statutory or administrative standards, but that is not this case. The hazards of churches supporting government are hardly less in their potential than the hazards of government supporting churches; each relationship carries some involvement rather than the desired insulation and separation. We cannot ignore the instances in history when church support of government led to the kind of involvement we seek to avoid.

> The grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state.[227]

Justice Douglas in his dissent was more closely attunded to economic realities: "A tax exemption is a subsidy."[228]

Any suggestion that a special tax exemption, deduction, or credit differs from direct government aid is untenable from an economic standpoint. The churches in *Walz* were placed in precisely the same economic position through the exemption as they would have been had they paid their property taxes and then received a direct grant from the city equal to the taxes paid.[229]

And only three years after *Walz*, a majority of the Court made it clear that the result in *Walz* rested on bases other than an economically unsound distinction between financial aid granted directly and financial aid provided through the tax system. In *Committee for Public Education and Religious Liberty* v. *Nyquist*[230] the Court was confronted with two New York statutes granting financial aid to parents of private school children: one, providing direct tuition reimbursement, and the other effecting the reimbursement through a system of tax credits. Under the direct grant program, parents of private school children with taxable incomes of less than $5,000 per year were entitled to tuition reimbursements of $50 per grade school child and $100 per high school child, subject to an overall limit of 50 percent of total tuition paid. The tax-credit program was for parents whose income exceeded $5,000 per year. The tax benefits were set to pick up where the direct tuition reimbursement system left off and the tax benefits gradually phased out as income increased. Benefits under both programs were available to parents whose children attended sectarian, nonpublic schools.

A three-judge District Court for the Southern District of New York[231] held that the direct reimbursement provisions were unconstitutional, but sustained the validity of the tax benefits. The Supreme Court affirmed the District Court as to the direct grants, but reversed as to the tax credits.

The direct grant program was held unconstitutional because it failed the "effect" test set forth above. The Court held that the tax benefit provisions were unconstitutional on the same grounds:

> In practical terms there would appear to be little difference, for purposes of determining whether such aid has the effect of advancing religion, between the tax benefit allowed here and the tuition grant allowed under [the direct grant program]. The qualifying parent under either program receives the same form of encouragement and reward for sending his children to nonpublic schools. The only difference is that one parent receives an actual cash payment while the other is allowed to reduce by an arbitrary amount the sum he would otherwise be obligated to pay over to the State. We see no answer to Judge Hays' dissenting statement below that '[i]n both instances the money involved represents a charge made upon the state for the purpose of religious education.'
>
> Appellees defend the tax portion of New York's legislative package on two grounds. First, they contend that it is of controlling significance that the grants or credits are directed to the parents rather than to the schools. This is the same argument made in support of the tuition reimbursements and rests on the same reading of the same precedents of this Court, primarily *Everson* and *Allen*. *Our treatment of this issue in* [*the Court's consideration of the direct tuition grant program*][50] *is applicable here and requires rejection of this claim* [emphasis added].[232]

> [50. Appellants [the Committee for Public Education and Religious Liberty (PEARL) and several individuals who were residents and taxpayers in New York, some of whom had children attending public schools] conceded in their brief that 'should the Court decide that Section 2 of the Act does not violate the Establishment Clause, we are unable to see how it could hold otherwise in respect to [the provision granting tax benefits]. Brief of Appellants, at 42-43. We agree that, under the facts of this case, the two are legally inseparable and that the affirmative of appellants' statement is also true, *i.e.*, if [the direct grant program] *does* violate the Establishment Clause so, too, do the sections conferring tax benefits.]

Justice Powell then went on to make clear the true basis for the Court's decision in *Walz:*

> Second, appellees place their strongest reliance on Walz v. Tax Commission,. . ., in which New York's proprty tax exemption for religious organizations was upheld. We think that *Walz* provides no support for appellees' position. Indeed, its rationale plainly compels the conclusion that New York's tax package violates the Establishment Clause.
>
> Tax exemptions for church property enjoyed an apparently universal approval in this country both before and after the adoption of the First Amendment. The Court in *Walz* surveyed the history of tax exemptions and found that each of the 50 States has long provided for tax exemptions for places of worship, that Congress has exempted religious organizations from taxation for over three-quarters of a century, and that congressional enactments in 1802, 1813, and 1870 specifically exempted church property from taxation. In sum, the Court concluded that '[f]ew concepts are more deeply embedded in the fabric of our national life, beginning with pre-Revolutionary colonial times, than for the government to exercise at the very least this kind of benevolent neutrality toward churches and religious exercise generally.' We know of no historical precedent for New York's recently promulgated tax relief program. Indeed, it seems clear that tax benefits for parents whose children attend parochial schools are a recent innovation, occasioned by the growing financial plight of such nonpublic institutions and designed, albeit unsuccessfully, to tailor state aid in a manner not incompatible with the recent decisions of this Court,[51] . . .[233]
>
> [51. The separate opinions of Justice Harlan and Justice Brennan also emphasize the historical acceptance of tax-exempt status for religious institutions.]

Justice Powell pointed out that the tax exemption involved in *Walz* satisfied the constitutional tests because it was "neutral" toward religion, and the financial aid given through the exemption minimized entanglement between church and state.[234] By contrast, the "purpose and inevitable effect [of the New York tax benefits] are to aid and advance those religious institutions, . . ." so that such benefits would "tend to increase rather than limit the involvement between Church and State."[235]

Another critical difference between the tax provision in *Walz* and that in *Nyquist* was discussed by Justice Powell:

> One further difference between tax exemption for church property and tax benefits for parents should be noted. The exemption challenged in *Walz* was not restricted to a class composed exclusively or even predominantly of religious institutions. Instead the exemption covered all

property devoted to religious, educational or charitable purposes. As the parties here must concede, tax reductions authorized by this law flow primarily to the parents of children attending sectarian, nonpublic schools. Without intimating whether this factor alone might have controlling significance in another context in some future case, it should be apparent that in terms of the potential divisiveness of any legislative measure the narrowness of the benefited class would be an important factor.[236]

Justice Powell's summing up makes it quite clear that in the view of the majority there is no difference in the constitutional tests to be applied to direct financial aid to religion and special tax benefits for religion:

> In conclusion, we find the *Walz* analogy unpersuasive, and in light of the practical similarity between New York's tax and tuition reimbursement programs, we hold that neither form of aid is sufficiently restricted to assure that it will not have the impermissible effect of advancing the sectarian activities of religious schools.[237]

Thus the decision in *Walz* is to be explained, not on the basis of a constitutional difference between tax aid and direct aid, but on (1) the historical antecedents of the property tax, and/or (2) the fact that the property tax exemption provided financial assistance to charitable institutions generally and had neither the primary purpose nor effect of aiding religious institutions.

The majority in *Nyquist* was, of course, careful to point out that its decision was not determinative of the constitutionality of the federal income tax deduction for charitable contributions:

> Since the program here does not have the elements of a genuine tax deduction, such as for charitable contributions, we do not have before us, and do not decide, whether that form of tax benefit is constitutionally acceptable under the "neutrality" test in *Walz*.[238]

It is not clear what the Court meant by a "genuine tax deduction." If the Court thought that there is some economic difference between a tax deduction and a tax credit, it was in error. Any program of federal tax aid can be structured as a deduction, a credit, or an exemption.[239]

The Supreme Court cases to date do support the proposition that special tax provisions whose purpose and effect is to provide financial aid that benefits organized religion are to be tested under precisely the same constitutional standards applicable to governmental programs that provide direct financial aid. The federal tax deductions for charitable contributions are not immune from constitutional scrutiny because they are tax provisions. Conversely, a direct financial aid program modelled on the tax deductions suffers no additional constitutional infirmities simply because it is a direct rather than a tax program.[240]

The Court's reliance in *Walz* on the historicity of the property tax exemption may have some continued, if uncertain, vitality. To the extent that the age of a financial program is relevant to its constitutional status, both the present income tax deduction and a direct matching program modelled on the deduction stand in a more favored status than would either an entirely new tax or direct aid program (such as was involved in *Nyquist*). In sum, then, if the 58-year history of the income tax deduction supports its constitutionality, that history likewise should support a direct matching grant program intended to mirror the deduction in most critical respects.

Constitutional Arguments Based on the Function of the Charitable Deduction in the Federal Income Tax System

The preceding material leads to the conclusion that on the basis of present case law, the constitutional status of the proposed direct matching grant program for charitable contributions and of the current charitable contributions deduction stand on the same footing. In each case, the question is whether the program can pass the three-fold test enunciated by the Supreme Court. The application of these tests to the proposed matching grant program is considered in more detail beginning on page 2503. There is another line of argumentation, however, which has not been passed on or indeed considered at any length by the Supreme Court that might bear on the constitutional status of both the current charitable contributions deduction and the proposed matching grant system. This argument focuses on the role that a charitable contributions deduction performs in an income tax system and attempts to draw constitutional conclusions from this functional analysis. In order to evaluate this position, it is useful first to examine the traditional analysis of the charitable contribution as a tax subsidy or tax incentive and then to consider possible objections to this analysis.

Traditional analysis of the charitable deduction as a tax expenditure or tax incentive. Why is it appropriate to analyze the charitable deduction as a tax incentive? The most straightforward answer to this question we have already seen: The deduction should be treated as an incentive because it is the economic equivalent of a direct grant by the federal government to encourage charitable giving.

But there is another, more theoretical, justification for considering the charitable deduction as a tax subsidy. This argument rests on the fundamental distinction between those tax deductions in an income tax whose function is to determine the net taxable income of the taxpayer and those deductions whose function is unrelated to the primary definitional task. Our federal income tax system imposes a tax on *net* income and hence allows deductions for a wide variety of business expenses necessary to reduce the taxpayer's gross receipts to net income which is the subject of the tax. There are other deductions, however, which are unconnected with this fundamental function of reducing gross income to net income. These are the various personal deductions, like the charitable deduction, which are unrelated to any expenses that the taxpayer has incurred in earning his income. These deductions are granted for a wide range of purposes, but they have in common the fact that they are *unrelated* to the "refining" of the taxpayer's net income subject to tax. They are allowed for reasons extraneous to the determination of the taxpayer's actual income. This separation of tax deductions into income-related deductions and other subsidy-granting deductions has its intellectual roots in the writings of Simons[241] and has taken on increasing importance in recent years.[242]

This line of analysis is helpful in examining the constitutional status of both the charitable contributions deduction and the proposed direct matching grant system. If the function the charitable deduction performs has nothing inherently to do with the income tax system itself but is only a provision "grafted on" in order to achieve certain ends unrelated to the determination of net income, then both it and a matching grant system performing the same function should logically be subject to the same standards of constitutional scrutiny.

There is nothing inherently "tax-like" in the charitable contributions deduction; it is merely a method among several methods of achieving certain governmental aims unrelated to the raising of revenues. This view of the charitable deduction has received almost universal acceptance by those who have considered the problem.

Congress. Congress, from its original enactment of the charitable deduction[243] to its most recent amendments of that provision,[244] has clearly considered the deduction to be an incentive or subsidy program unrelated to the costs incurred in the production of income. This congressional view also evidences itself in a number of the current structural provisions in the Internal Revenue Code. For example, the deduction of charitable contributions is made from adjusted gross income *after* the deduction of business expenses has been effected; the charitable deduction is excluded from the net operating loss carryover; and percentage limitations are applied to the charitable deduction. All of these provisions indicate a distinction between *business* deductions and the charitable deduction. In addition, recent actions to include tax provisions that are primarily intended to achieve extra-fiscal ends in the formal congressional budgetary process indicate the congressional acceptance of the view that the charitable contributions deduction is not a net-income defining deduction, but is rather a tax incentive or tax expenditure.[245]

The Executive Branch. The Treasury Department has from 1968 published a list of "tax expenditures" which has included, since its inception, the charitable contributions deduction. Presenting the charitable deduction as a "tax expenditure" clearly indicates the Treasury understanding that the deduction is not a business deduction but performs an incentive function in the federal tax system. The 1976 Budget includes the charitable deduction as a "tax expenditure."[246]

The Courts. The Supreme Court has never been called on directly to analyze the role of the charitable deduction in the federal income tax system. However, lower federal courts have been quite explicit in treating the charitable deduction as an incentive-type deduction and not as a business deduction. For example, in *McGlotten v. Connally,*[247] the court stated:

> We think there is little question that the provision of a tax deduction for charitable contributions is a grant of federal financial assistance within the scope of the 1964 Civil Rights Act. 'The charitable contribution deduction is a special tax provision not required by, and contrary to, widely accepted definitions of income applicable to the determination of the structure of an income tax.' It operates in effect as a government matching grant and is available only for the particular purposes and to the particular organizations outlined in the Code.

Similarly, in *Green v. Connally*[248] the court referred to the tax benefits provided to charities through exemptions and deductions as "in the nature of a matching grant." Other lower court opinions are to the same effect; see, e.g., *Green v. Kennedy*[249], *Pitts v. Department of Revenue.*[250]

The Charities. The charities themselves clearly view the function of the charitable deduction as providing an incentive or subsidy in order to encourage charitable giving. All of their testimony in the recent amendments to the charitable deduction focus on the incentive effect and the necessity of preserving such an incentive device. No arguments are based on the need for a charitable deduction as a business expense in order to reflect clearly net taxable income.[251]

The Commentators. With the exceptions discussed below, the overwhelming majority of the commentators on the charitable deduction have based their analyses on the principle that the charitable deduction is not to be viewed as a business deduction necessary in the refinement of the definition of what is to be taxed but is to be treated as a subsidy program. [See, e.g., Surrey, *Pathways to Tax Reform* (1973), pp. 19-21, 223-32, 287-88, 372-80; Surrey, "Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance," 84 Harv. L. Rev. 352 (1970); McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction," 27 Tax L. Rev. 377 (1972); Stone, "Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy," 20 U.S.C. Tax Institute 27 (1968); Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," 20 Nat'l. Tax. J. 1 (1967).]

Minority view of deduction. As noted above, there is a minority of tax analysts who take a different view of the charitable contributions deduction. It is useful to examine briefly their theories to determine if adoption of their views would affect one's view of the constitutional tests to be applied to the deduction and the direct matching grant.

The generally accepted view that the charitable contributions deduction constitutes an extraneous subsidy feature of the tax law rests on the fundamental distinction between deductions, such as business deductions, that are *essential* for the determination of net income and other deductions, such as the charitable deduction, that are unrelated to this determination. If one rejects this fundamental distinction, then all deductions (and indeed all other tax provisions) stand on an equal footing and it is inappropriate to analyze the latter category as the functional equivalent of federal spending programs.

This view of the Internal Revenue Code was presented with some force by a noted constitutional and tax scholar, Professor Boris I. Bittker of Yale Law School, several years ago in his article, "A 'Comprehensive Tax Base' As a Goal of Income Tax Reform," 80 Harv. L. Rev. 925 (1967), where he stated that "the central source of the difficulty [in seeking tax 'preferences'] is the fact that the income tax structure cannot be discovered but must be constructed: it is the final result of a multitude of debatable judgments." As a result of this position, Bittker "question[ed] the validity of allowing constitutional obligations" to turn on whether taxing provisions involve "subsidies" or "income defining" provisions.[252]

It is difficult to see how the Bittker view of the tax deduction changes the analysis of the constitutionality of the matching grant system that is developed in the following section (page 2503). Professor Bittker at times seems to assert that because, in his view, there is no difference between a business expense deduction and the charitable contributions deduction as a conceptual matter, *all* tax deductions are insulated from constitutional challenge just because they are tax provisions.[253] This view plainly must be rejected as a substantive proposition; if adopted, it would mean that every legislative expenditure program could be protected from constitutional challenge by the simple expedient of casting that spending program in the form of a special tax exemption, deduction, credit, deferral, or rate provision. But if the only practical result of the Bittker analysis is to deny standing to individuals to challenge the constitutionality of tax provisions, it has no effect on the decision to switch to a direct grant system, since the direct grant system appears to withstand constitutional challenge on the merits (see p. 2503).

On the other hand, Professor Bittker's position can be read more narrowly. He may simply be asserting that all tax provisions stand on the same footing.

But if this is so, then *Walz* and *Nyquist* are clear that such provisions must be analyzed under the constitutional tests applicable to any other form of economic benefit.[254] (This analysis is undertaken in the following section.) But the Bittker theoretical view of the charitable deduction does not affect either the fact that the analyses will be made by the courts or the constitutional standards that will be applied.

While the Bittker analysis rejects the distinction between tax "subsidies" and income-defining provisions, a recent article by Professor Andrews,[255] although accepting this distinction, takes a position that the charitable contribution should be viewed as a deduction necessary to the "rational refinement in the definition of what it is we seek to tax." He concludes from this characterization that it will thus be "easier to defend" the constitutionality of the deduction.[256] Andrews' analysis rests on a technical elaboration of the concept of "consumption" in reaching the conclusion that charitable contributions are not consumption and hence a deduction for charitable contributions should be treated as a structural provision in the income tax law.[257]

Professor Andrews' argument is too complex to be examined in detail here. It may be observed that he really focuses on the issue of how to treat charitable contributions in a *consumption tax*.[258] But this argument goes far beyond what any court has considered as relevant in testing the constitutionality of the charitable contributions deduction in an *income tax*. The Andrews analysis does not change the position of the arguments concerning the constitutional status of the deduction in an income tax system or of the matching grant system. Acceptance of his position would presumably merely protect the deduction from constitutional challenge because it would be difficult, if not impossible, for individuals to meet the present standing requirements. But this, of course, does not mean that a direct grant system modelled on the tax system is unconstitutional. If, as is argued in the next section, the matching grant system is constitutional on the merits, then the theoretical difference between the traditional view of the deduction and Andrews' theory is of no practical consequence.

Conclusion

The overwhelming majority of authority supports the proposition that the function of the charitable deduction in an income tax system is as a subsidy or incentive for contributions to charities and is the functional equivalent of a federal matching grant program. As such, the constitutional problem involved in the current deduction and in the proposed matching grant system would be identical. Even where the "subsidy" character of the charitable deduction is not accepted, the "economic equivalence" between the charitable deduction and a matching grant program must be recognized and the fundamental tests developed by the Supreme Court would be applied to determine the constitutionality of either the charitable deduction or the economic equivalent matching grant system.

The Constitutional Status of Direct Federal Financial Aid to Charitable Organizations, Including Religious Institutions

The direct matching grant proposal first will be analyzed under the tripartite test developed by the Supreme Court under the Establishment Clause. Then its status under the Free Exercise Clause will be examined. The following discussion assumes that the difficult hurdle of standing to challenge the constitutional validity of the system (or of the present tax deduction) can be successfully met.[259] Admittedly, one's view of the likely success of a complainant on the standing issue might affect one's judgment as to the seriousness of the constitutional issues involved. But, the purpose of the following analysis is to try to examine the constitutional issues on their merits, apart from the standing problem.

Secular Legislative Purpose

The overarching purpose of the proposed direct matching grant system is the same as that of the charitable contributions deductions: to provide federal financial assistance to charitable organizations through the mechanism of providing incentives to potential donors to such institutions. There are 220,000 charitable organizations, contributions to which will qualify for the present deduction.[260] These same organizations will be qualified donees under the matching grant system.[261] Thus the federal financial aid will be provided to hospitals, educational institutions, community funds, the Red Cross, research organizations, and religious institutions. While religious institutions are included in the group to be aided, the purpose of both the deduction and the matching grant is to aid charity, not religion as such.[262]

The Supreme Court in analyzing secular purpose has considered as an important factor the breadth of the class to be benefited by the statutory provision. As set forth above, in *Committee for Public Education* v. *Nyquist*, Justice Powell speaking for the majority concluded that "in terms of potential divisiveness of any legislative measure the narrowness of the benefited class would be an important factor."[263] He emphasized that one major difference between *Walz* and *Nyquist* was that the property tax exemption was accorded to all nonprofit institutions, not just religious organizations. The charitable contribution deduction and the matching grant are similarly structured. Justice Harlan has written:

> As long as the breadth of exemption includes groups that pursue cultural, moral, or spiritual improvement in multifarious secular ways, including, I would suppose, groups whose avowed tenets may be antitheological, Atheistic, or agnostic, Ican see no lack of neutrality in extending the benefit of the exemption to organized religious groups.[264]

Professor Bittker in the following colloquy concluded that the scope of the class to which the present charitable deductions benefits are extended should sustain its constitutionality:

> Professor Paul R. McDaniel, Boston College Law School: I would like to ask Professor Bittker a question about the church-state issue: If the only deduction in the federal tax system were one for contributions to churches, would that be held unconstitutional?
>
> Professor Boris I. Bittker, Yale Law School: I think there is a possibility that it would be. It would involve singling churches out from other non-profit institutions, and it would be much easier to say that that was an aid to religion than to say that general aid to all types of nonprofit institutions is an aid to religion. When all nonprofit institutions are treated the same, however, it is arguable that a tax on income simply doesn't make sense for such groups.
>
> Professor McDaniel: It seems to me, then, that the case is pretty clear that the matching grant system I have proposed meets that test; it gives the same benefits to all types of charities just as the present system does.

> I agree with your response, but I would conclude from it that the proposed matching grant system does not lead to a constitutional problem; or at least not any that is not present in the existing system.[265]

The matching grant proposal would continue the policy of the charitable deduction that allows the donor to benefit a broad class of philanthropic organizations. The Internal Revenue Service has determined that of the more than 220,000 organizations eligible to receive tax-deductible gifts, slightly less than one fourth are religious organizations. However, according to one estimate, religious organizations received an estimated 41 percent of all charitable donations in 1973; but another has placed the figure at about 60 percent.[266]

In *Nyquist*, the tuition aid went to 20 percent of the state's school population that attended private schools. Approximately 85 percent of these schools were church-affiliated. Thus virtually all of the state funds went to a relatively small segment of the pool of potential beneficiaries (that is, *all* school children of elementary and secondary age) the vast majority of whom attend church-related schools. Despite this fact, the Court had no difficulty in concluding that the statutes in question satisfied the "secular legislative purpose" test:

> In applying these criteria to the three distinct forms of aid involved in this case, we need touch only briefly on the requirement of 'secular legislative purpose'. As the recitation of legislative purposes appended to New York's law indicates, each measure is adequately supported by legitimate, nonsectarian state interests. We do not question the propriety, and fully secular content, of New York's interest in preserving a healthy and safe educational environment for all of its school children. And we do not doubt—indeed, we fully recognize—the validity of the State's interest in promoting pluralism and diversity among its public and nonpublic schools. Nor do we hesitate to acknowledge the reality of its concern for an already overburdened public school system that might suffer in the event that a significant percentage of children presently attending nonpublic schools should abandon those schools in favor of the public schools.[267]

It thus seems unlikely that the "secular legislative purpose" test will defeat the federal aid to charity granted through the present deductions or the proposed matching grant system. The desire to aid *all* charitable organizations, to encourage pluralism and diversity in our approach to economic and social problems, to disperse among individuals the power over certain federal funds—all of these seem more than adequate to satisfy the "secular legislative purpose" requirement.

Primary Effect

The second element of the *Lemon* test is whether the program of government aid has a principal or primary effect that neither advances nor inhibits religion.

This "effect" test is surely the most difficult to surmount, either for the present charitable deduction or the proposed direct matching grant system. Under either system, federal funds in substantial amounts obviously end up in religious institutions.[268]

Certain problems can be set aside at the outset. It makes no constitutional difference that the present deduction nominally directs its benefits to individual donors, whereas the matching grant system would provide federal checks to the religious institutions themselves. As has been demonstrated in Chapter II, the present deduction system is simply a mechanism whereby the federal government denominates the donor as the paying agent for its share of the gift to charity. Further, the Court in *Nyquist* firmly rejected the proposition that there was any constitutional difference between paying funds directly to religious organizations and paying funds to individuals where "the effect of the aid is unmistakably to provide desired financial support for nonpublic, sectarian institutions."269

The critical factor in *Nyquist* was that the financial aid given by the state failed to differentiate between secular and religious education functions: "Indeed, it is precisely the function of New York's law to provide assistance to private schools, the great majority of which are sectarian."270

There are two aspects to the "secular versus religious" functions distinction. One is whether the aid is made available to all institutions, sectarian and nonsectarian alike. As to this aspect, Justice Brennan in his concurring opinion in *School District v. Schempp* wrote:

> Nothing we hold today questions the propriety of certain tax deductions or exemptions which incidentally benefit churches and religious institutions, along with many secular charities and nonprofit organizations. If religious institutions benefit, it is in spite of rather than because of their religious character. For religious institutions simply share benefits which government makes generally available to educational, charitable and eleemosynary groups. There is no indication that taxing authorities have used such benefits in any way to subsidize worship or foster belief in God. And as among religious beneficiaries, the tax exemption or deduction can be truly non-discriminatory, available on equal terms to small as well as large religious bodies, to popular and unpopular sects, and to those organizations which reject as well as those which accept a belief in God.271

Justice Powell for the majority in *Nyquist* also observed:

> Allen and Everson differ from the present case in a second important respect. In both cases the class of beneficiaries included *all* school children, those in public as well as those in private schools. See also Tilton v. Richardson, . . . in which federal aid was made available to all institutions of higher learning, and Walz v. Tax Commission, . . . , in which tax exemptions were accorded to *all* educational and charitable nonprofit institutions. We do not agree with the suggestion in the dissent of THE CHIEF JUSTICE that tuition grants are an analogous endeavor to provide comparable benefits to all parents of school children whether enrolled in public or nonpublic schools. . . .
>
> The grants to parents of private school children are given in addition to the right that they have to send their children to public schools 'totally at state expense.' And in any event, the argument proves too much, for it would also provide a basis for approving through tuition grants the *complete subsidization* of all religious schools on the ground that such action is necessary if the State is fully to equalize the position of parents who elect such schools—a result wholly at variance with the Establishment Clause. [emphasis added.]
>
> Because of the manner in which we have resolved the tuition-grant issue, we need not decide whether the significantly religious character of the statute's beneficiaries might differentiate the present case from a case involving some form of public assistance (e.g., scholarships) made

> available generally without regard to the sectarian-nonsectarian, or public-nonpublic nature of the institution benefitted. See Wolman v. Essex, 342 F.Supp. 399, 412-413 (SD Ohio 1972), aff'd, 409 U.S. 808, 93 S.Ct. 61, 34 L.Ed. 2d 69 (1972). Thus, our decision today does not compel, as appellees have contended, the conclusion that the educational assistance provisions of the G.I. Bill, 38 U.S.C. §1651, impermissibly advance religion in violation of the Establishment Clause.[272]

The second aspect of the "secular versus religious" functions distinction involves situations where government financial aid is in fact paid to religious institutions as a part of a broader secular purpose. In these cases the question is whether the aid to the religious institution is clearly restricted to its secular activities. The fact that religious organizations benefit financially from a governmental aid program is not of itself fatal to the provision, if the aid is incidental to a program that serves a more generally inclusive purpose. Justice Powell, in *Hunt* v. *McNair*, wrote:

> Whatever may be its initial appeal, the proposition that the Establishment Clause prohibits any program which in some manner aids an institution with a religious affiliation has consistently been rejected. . . Stated another way, the Court has not accepted the recurrent argument that all aid is forbidden because aid to one aspect frees it to spend its other resources on religious ends.[273]

In *Tilton* v. *Richardson, supra,* the Court considered the constitutionality of Title I of the Higher Education Facilities Act of 1968 which provides direct federal construction grants for college and university facilities. Any facility to be used for sectarian instruction or religious worship or primarily by any department of divinity is to be excluded. The issue considered by the Court was whether the fact that the act authorized aid to church-related institutions (with the above-mentioned restrictions) violated either the Establishment or Free Exercise Clause. The determinative test was held to be not whether some benefit accrues to a religious institution, "but whether its principal or primary effect advances religion." The Court rejected the argument that government cannot subsidize any activity of an organization that is church-related, a claim based upon language in *Everson* that the Establishment Coause barred any "tax . . . levied to support any religious activities or institutions . . . whatever form they may adopt to teach or practice religion."[274]

The line is obviously difficult to draw. Financial aid to religious institutions for purely secular purposes, such as police and fire protection, sewage disposal, highways and sidewalks (*Everson*), or textbooks for secular courses (*Allen*), or nonsectarian buildings (*Tilton*), is permissible even though the religious institutions obviously benefit by having funds freed up for sectarian purposes. On the other hand, where the aid is given in a form such that is impossible to isolate the secular from the religious function (payments for costs of teaching secular subjects in religious schools, *Lemon* v. *Kurtzman*), or where the government makes no effort to isolate the secular from the religious function and the aid in fact benefits almost exclusively sectarian institutions (*Nyquist*), then the "effect" test is not met.[275]

On which side of the line do the present tax deductions and the proposed matching grant fall? The benefits under each system are provided to religious institutions not because they are religious but because they comprise a part of the larger group of organizations to be aided. But, with respect to the funds that in fact end up in religious organizations, neither system makes any attempt to isolate sectarian from secular functions and restrict the financial aid only to the secular aspects.

At this stage in the development of the "effect" test it is impossible to give a definitive answer to the question. Two propositions—the first tentative and the second definite—can, however, be put forth:

1. The present tax deduction system for contributions to charity would probably be upheld under the "effect" test since it provides aid impartially to secular and religious institutions alike. *Walz* gives support to the view that where this is the case, it is unnecessary further to distinguish between the secular and sectarian functions of the religious institutions that receive the aid.

2. The proposed matching grant system stands in the same constitutional status as the present tax deduction. If the present tax deduction system passes the "effect" test, so too does the matching grant proposal; if the deduction system fails that test, the direct matching grant system will fare no better.

Excessive Entanglement With Religion

The "entanglement" test is not neatly separable from the "effects" test. It is the relationship between the effect of a statute and its potential for entanglement that will be determinative of the validity of a particular statute.[276] The three-judge District Court in *Wolman* v. *Essex* refined and clarified the "entanglement" concept when it suggested that a statute must not invoke excessive "administrative" or "political" entanglements.[277]

It is useful first to identify the potential for entanglement in the present tax deduction system:

1. As discussed above, some unspecified portion of federal funds is paid to or for the benefit of sectarian religious purposes each year.
2. In connection with providing that aid, congressional actions do have an effect on the activities of churches. For example, in 1969 Congress for the first time imposed the unrelated business income tax on churches, albeit with certain provisions more favorable to churches than other charitable organizations (see §512(b) (12) and §514(b) (3)(E)). If that tax is incurred, a tax return must be filed. Further, churches were exempted from the information return filing requirements that apply to other charitable organizations (§6033(a)(2)).
3. The amount of federal funds going to religion is varied from time to time by direct and indirect congressional action. Thus, Congress may change the amount of the allowable charitable deduction (or repeal it entirely), raise or lower tax rates, alter the standard deduction, all of which actions will increase or decrease the federal funds going to religion.[278]
4. Religion is involved in government as a result of the aid provided through the deduction system. For example, religious organizations testified and lobbied with respect to the proposed changes in the Tax Reform Act of 1969.[279]

The same degree of government entanglement with religion is involved in the proposed direct matching grant system. Some federal funds will go to churches with no exclusion for sectarian functions; churches will not be required to file any returns not required under the deduction system; church accounts and activities would not be audited by IRS agents; the amount going to religion can be modified by congressional action from time to time; and churches will undoubtedly continue to press their case in Congress when legislation affecting their federal aid is involved.

The critical question for both the present deduction system and the proposed matching grant system thus is, given some "entanglement" under either system, "whether the involvement is excessive, and whether it is a continuing one calling for official and continuing surveillance leading to an impermissable degree of entanglement."[280]

In *Walz,* the Court concluded that property tax exemption for churches did not involve the proscribed degree of entanglement. The Court found no nexus between tax exemption and the establishment of religion. In substantial part, the conclusion was based on the historical fact that the exemption had not in fact led to a state-established church.[281]

In *Nyquist,* on the other hand, the Court concluded that the tax benefits provided to parents of parochial school children contained a significant "potentially divisive political effect." Noting that "aid programs of any kind tend to become intermixed, to escalate in cost and to generate their own aggressive constituencies," Justice Powell concluded that where emotionally charged issues of church-state relations were involved "the potential for serious divisive political consequences needs no elaboration." This prospect was not conclusive in testing the law under consideration, but its presence served as a "warning signal" to be considered.[282]

With these Supreme Court declarations as background, we can assess the *administrative aspect* of the "entanglement" test on a federal program of financial aid to charities which includes churches.

One, the fact that, as a part of a broader program, aid results to churches is not of itself determinative in the entanglement issue (*Walz*).

Two, *Walz* would indicate that when aid to churches results from a broad program of financial aid, it is unnecessary to distinguish between the sectarian and secular functions of the religious institutions.

Three, the history of the tax deductions reveals no effort by the federal government to establish a state church.

Four, the deduction and the proposed matching grant are designed to insure a minimum of federal regulation and control over church activities.

The potential for administrative entanglement thus seems minimal under both the present deduction and the proposed matching grant.

The other aspect of the "entanglement" test is its potential for *political divisiveness.* The sweeping language of Justice Powell in *Nyquist* gives cause for concern.[283] However, the fact that the aid program involved in *Nyquist* had no other purpose than to aid religious institutions seems critical. Any review of the New York law by the state legislature would necessarily—and perhaps exclusively—involve church-state issues. On the other hand, the history of the changes in the federal charitable contributions deduction reveals no such conflicts. Undoubtedly, this is because of the fact that the deduction aids a far larger group than just religious institutions. The same would be true of the direct matching grant program.

Some have suggested that "entanglement" problems might be alleviated if the direct matching grant system were applied to all non-religious charitable institutions, with the present deduction being continued for religious organizations. In fact, such a split system appears more likely to run afoul of the entanglement test since isolation of religious institutions in a single identifiable program is fraught with the potential for political divisiveness that the First Amendment seeks to forestall. A program that aids all charities (and one in which religious institutions receive substantially less than half the aid) does not carry this same potential. The present deduction program and the proposed matching grant system thus should pass constitutional muster under the "entanglement" test.

Free Exercise. The proposed matching grant system must also avoid interfering with the free exercise of religion. If the grant system includes religious institutions in the same fashion as the present deduction system, then no problem is presented with respect to the Free Exercise Clause.

In considering the proposed matching grant system, the above suggestion that the proposed system extend only to secular charitable organizations would appear to run afoul of the Free Exercise Clause just as would a provision granting a charitable contribution deduction to all organizations except religious institutions.

While the present charitable deduction provision has not been challenged in the courts, other federal and state programs in which religious organizations received monies have been litigated. The Supreme Court has stated that it would be an abridgement of free exercise to deny religious organizations competition for government contracts or receipt of government services simply because they are religious organizations.[284] Additionally, the Court has recognized that individual citizens should not be excluded "because of their faith, or lack of it" from the benefits of general welfare legislation.[285]

In *Schempp,* Justice Brennan wrote that the state may not interfere with an individual's choice of educational institution whether private or public "by diminishing the attractiveness of either alternative . . ."[286]

In *Everson,* the Court wrote of the First Amendment:

> That Amendment requires the state to be neutral in its relations with groups of religious believers and non-believers; it does not require the state to be their adversary.[287]

In sum, in the state's relationship with religion an attitude of "benevolent neutrality" must be maintained.[288] Thus, for example, the employment by the government of chaplains conducting religious services held in government-built chapels for the armed services is not done to promote religion, but rather to protect the free exercise thereof. On a similar principle, once the threshold decision is made by the government to replace the deduction system with matching grants, as part of a greater legislative purpose, the exclusion of religious organizations would have the effect of making those charities decidedly less attractive to potential donors, as well as placing them at an economic disadvantage when compared with similar secular charities. Hence, under the foregoing tests, exclusion of religious institutions from a matching grant system appears likely to run afoul of the Free Exercise Clause.

Further difficulties are created if the matching grant proposal were instituted for secular charities and the tax deduction retained for contributions to religious institutions. The difficulty here is that while aid is being given to all religious institutions, both the means of effecting that aid and the financial results of the two programs differ solely because of the fact that one group of recipients consists of religious institutions. To the extent that the aid given to churches under the deduction system was more favorable than that accorded secular charities under the matching grant system, the Establishment CLause may be violated; to the extent religious institutions receive relatively less aid than secular charities, the Free Exercise Clause may be violated.

Congress could attempt to alleviate constitutional problems by confining aid to religious institutions to their nonsectarian functions. This action could be taken either with respect to the present tax deduction or the proposed matching grant. Here the problem is that in attempting to arrive at definitions that isolate sectarian from secular functions, Congress may well run afoul of the "entanglement" test under the Establishment Clause.

Conclusion

The above examination of the existing constitutional law principles applicable to the matching grant proposal indicates that it should be sustained against any constitutional challenge. It benefits the broad class of all charitable intsitutions, it is supported by nonsectarian federal interests, it neither advances nor inhibits religion. It simply converts the result of the present deduction system into a more rational method of delivering the federal share of charitable giving.

Appendix A

Note on Economic Theories of Sacrifice

There is an unusually large body of literature on precisely the question, What is equal sacrifice? Most of it stems from the turn-of-the-century debate over proportional versus progressive taxation. Out of this debate emerged three different theories of equal sacrifice. Which of these theories one finds more persuasive helps determine whether one favors a progressive matching grant schedule, a flat matching grant, or a declining matching grant schedule.

Basic to an understanding of these theories is the economic doctrine known as the declining marginal utility curve for income. In simple terms, a utility curve means that a dollar does not have the same meaning or utility for all people. By saying that the utility curve is declining one asserts that a rich person places less value on each dollar than a poor person. While economists have not proved conclusively that there is such a thing as a declining marginal utility curve for income, it is a commonly held assumption.[1] We sense that because he has many dollars, the rich person will spend each one with less concern and will be willing to work less hard to acquire each one. But the fact that the utility curve has not or perhaps cannot be accurately measured does make it impossible to measure equal sacrifice with scientific certainty.

The three theories of equal sacrifice advanced by economists and social theorists are equal absolute, equal proportional, and equal marginal sacrifice.[2] *Equal absolute sacrifice* means that to have sacrificed equally, each person must give up the same total units of utility. *Equal proportional sacrifice* means that each must be required to give up an equal percent of his total utility derived from his income in order to equalize the sacrifice. *Equal marginal sacrifice* means that to have sacrificed equally, the last dollar given by each donor must have the same utility.[3]

If we assume that there is no utility curve, but instead that every person values money equally, what would a matching grant program look like based on each of the sacrifice theories? Under the equal absolute theory the match would have to be based solely on the size of the donation. Regardless of the income of the donor, every contribution would receive, say, a 30 percent match. Under the equal proportional theory, the match would increase as the percent of income donated increased. If we assume no utility curve, the equal marginal theory produces the same matching program as the equal absolute, since the last dollar given by every donor will always have the same utility.

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[1] Musgrave, *The Theory of Public Finance* (1959), 102-105.

[2] See Musgrave and Peacock, eds., *Classics In The Theory of Public Finance* (1958), particularly the articles by A. Cohen-Stuart and F. Edgeworth.

[3]

Equal Absolute Sacrifice	$U(Y)-U(Y-T)$
Equal Proportional Sacrifice	$\frac{U(Y)-U(Y-T)}{U(Y)}$
Equal Marginal Sacrifice	$\frac{dU(Y-T)}{d(Y-T)}$

U = Utility, Y = Income, T = Tax
Musgrave, *The Theory of Public Finance*, 96.

If however, we take cognizance of the commonly held belief that it is easier for the rich to give than the poor, that is, that the income utility curve is declining, what will our matching grant program look like? The only sacrifice theory which provides a ready answer is the equal marginal theory.

In practice the equal marginal theory of sacrifice would find equal sacrifice only when the rich person has given away all of his income until what he has left for voluntary consumption equals what the poor person has left for voluntary consumption after he has made his contributions. For example, the person who has a $10,000 income and gives 3 percent to charity may have foregone buying a new car this year because of his contribution, while the person who has a $100,000 income and gives 3 percent of it to charity already has three new cars and has perhaps given up his second trip to Europe this year in order to make his contribution. The sacrifice of these people will not be equal until the richer person has given up the same opportunity to buy a new car or has foregone the opportunity to consume equally necessary and desirable goods. To reach that point he has to give away all his income until what he has left is the same as what the person with the $10,000 has left. A prominent proponent of this sacrifice theory, Thomas N. Carver, noted: "From the strictly utilitarian standpoint the individual who measures his obligation to society by his total income is less to be commended than the individual who determines whether he has fulfilled his social obligations by considering not how much he has given, but how much he has left."[4]

It would seem at first glance that under both the equal absolute and equal proportional theories of sacrifice, a declining utility curve would require a match that got progressively smaller as a donor's income increased. Economists have shown, however, that this is not necessarily the result.[5] Musgrave, in discussing progressive and proportional taxation, submits the following:[6]

> If marginal income utility is constant, equal proportional sacrifice clearly calls for a proportional rate of tax. If the schedule now tips downward (declining marginal income utility) while the tax payments remain unchanged, it would seem that the high-income taxpayer surrenders a lesser fraction of his total income utility than does the low-income taxpayer. Thus a progressive rate schedule appears to be called for. But as Cohen-Stuart and Edgeworth have shown such a conclusion is not valid. The mere condition of a declining marginal income utility schedule does not always lead to progression.

All that the law of declining marginal utility requires is that the last dollar of a $1,000 income provides less satisfaction than the last dollar of a $100 income. From this one cannot assert that to obtain equal absolute or equal proportional sacrifice the reward system need be progressive. To assert this conclusion we must be able to state that the last 1 percent of a $1,000 income ($10) provides less satisfaction than the last 1 percent of a $100 income ($1). This statement does not, however, follow from the law of diminishing marginal utility.

Where does that leave us in determining what is the best measure of equal sacrifice? The equal marginal theory of sacrifice takes a rather radical approach to equity and by doing so destroys much of the incentive of a matching grant program. The poor who can afford at most to make relatively small charitable contributions are given high price incentives to give more, while the rich who can afford to make large contributions are given almost no price incentives unless they meet the totally unrealistic requirement of first giving away most of their wealth. This loss of incentive makes a schedule of matches following the equal marginal theory of sacrifice inappropriate if we wish to construct a program that operates both as an incentive and as a reward throughout the income scale.

A non-progressive schedule of matches based on the equal absolute theory of sacrifice may not seem fair in a society that resists the notion that the wealthy should control the bulk of federal funds just because they are wealthy. The assumptions here are similar to those underlying the belief that a progressive tax rate structure is more fair than a proportional rate structure.

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4. T. Carver, "Minimum Theory of Sacrifice," 19 Pol Sci. Q. 61, 76 (1904).

5. A. Pigou, *A Study In Public Finance* (3d ed. 1951), 86; F. Edgeworth, 2 Papers Relating to Political Economy (1925), 239; Seligman, *Progressive Taxation in Theory and Practice* (1908) 218-222. Musgrave, *The Theory of Public Finance,* 101-102.

6. Musgrave, ibid., 100.

The middle-ground approach from the standpoint of both measuring equal sacrifice and serving as an incentive to giving would seem to be the proportionate theory of equal sacrifice, assuming a constant utility curve. Measuring equal sacrifice by the percent of income given to charity may be perceived as better than an equal absolute match because it recognizes, to some extent at least, the relative ease with which the wealthy can give each dollar to charity and yet does not take such a radical leap as the equal marginal theory (that is, a declining match), thereby preserving the matching grant as an efficient price incentive for upper-income donors.

The assumption of a constant utility curve would seem to be a practical necessity. Even though common sense observations tell us it must be declining, we have seen that this observation does not necessarily lead to a matching schedule different from one based directly on percent of income donated. In addition there is considerable doubt that interpersonal utility comparisons can ever be made in a meaningful fashion. Income is not the only determinant of the satisfaction an individual derives from his consumption ability. If a person's values are extremely non-materialistic, it would be less of a sacrifice for him to forego material consumption in order to make a charitable contribution. He is giving away something that has little value for him and to be fair he should be rewarded less than the person who values highly the material things he could have bought for himself with the money given away. Likewise, it takes much greater effort for the miser to make a charitable contribution than for the spendthrift. Of course, there is no way that the government can measure the value priorities of every citizen to find out who is materialistic and who is not, nor would it necessarily be desirable even if it were possible.

A progressive matching grant schedule perhaps opts for the conservative in not allowing for the possibility that it may be less of a sacrifice for a rich person to give away 5 percent of his income than for a lower-income person to donate 5 percent of his income. But this is a conscious and justifiable tradeoff to obtain a greater incentive effect in the matching grant schedule to encourage higher levels of private giving to charity.

Appendix B

Note on Refundable Tax Credit

As the text has indicated, any tax expenditure program can be restructured as a direct expenditure program. The reverse is also true. Thus, some might agree with the contours of a direct matching grant system, but still—perhaps for some felt psychological reasons—to see the proposal run through the tax system. Technically, the result can be achieved. A tax-credit system could be devised to reflect the proposed direct system. If the credit were refundable and adopts the same matching schedule (either flat or progressive), it would not differ in economic effect, pluralism, and expenditure equity from the proposed direct system.

There are, however, other differences between the proposed direct system and a refundable tax credit exactly reflecting that system. These differences will undoubtedly be given differing weight depending upon the viewpoint of those evaluating the alternatives.

From a tax standpoint alone, the refundable credit, while it removes the verticle inequity of the present deduction, does continue horizontal inequity. That is, two persons with the same incomes will pay different taxes solely because one has made a charitable contribution. This tax inequity really cannot be resolved so long as one attempts to run revenue collection and revenue disbursement procedures through the same system.

Use of the refundable tax credit may also have another undesirable effect on the tax system. Congress to date has not shown any marked ability to differentiate between types of tax credits. The mere existence in the tax system of the refundable tax credit for charitable contributions may thus encourage Congress to adopt too readily the tax-credit mechanism without first thinking through what a direct expenditure program should look like.

A practical political result of the refundable tax credit technique may be to maintain jurisdiction over the federal-private matching program in the House Ways and Means Committee and the Senate Finance Committee. Presumably, although not certainly, the proposed direct matching grant system would come under the substantive jurisdiction of the House Education and Labor Committee and the Senate Labor and Public Welfare Committee. (Under the new budget procedures, the appropriations for either the tax expenditure system or the direct system would be subject to the jurisdiction of the Committee on the Budget.) It would appear that consideration of the program would be conducted better in the committees dealing regularly with education and public welfare matters. Whether one agrees with this judgment, however, may depend on his political assessment of the various committees.

From an administrative standpoint, the cost of administering the refundable tax credit might well exceed the proposed direct grant system. Under both a refundable tax credit and the direct systems, the IRS would receive forms from each donor (or perhaps from each donee organization) listing contributions (see Chapter 5, page 2477). However, under the direct system the IRS would be required to disburse a maximum of 220,000 checks to the organizations that qualify for the federal funds. A refundable tax credit system would require, however, that the IRS issue checks to every donor for whom the credit produces a negative tax liability. The pool of potential donors to whom refund checks might have to be issued substantially exceeds 15 million individuals. Thus the costs of preparing and mailing checks under the refundable tax credit mechanism could significantly exceed those required to administer the direct grant system.

From the standpoint of the charities, the refundable tax credit also has different effects. As a fund-raising matter, the direct matching grant system permits the fund raiser to ask the donor to write out a smaller check, since the charity will collect the balance from the Treasury. A refundable tax credit requires that charitable fund raisers ask the individual donor to write out a check on his bank account for both the government grant and his own gift. The donor must then collect from the government when he files his tax return on April 15 of the next year. Thus the direct matching grant system would appear to make the fund raiser's task easier. On the expenditure side, the charitable organization may of course have the funds in hand more quickly under the refundable credit program since it gets the government share in the donor's check. The extent of the advantage that this procedure provides for charities in planning their expenditure programs depends on how frequently the Treasury would disburse funds under the direct grant system (see Chapter V, page 2478.

On balance, it does not appear that the differences between a refundable tax credit and the proposed direct grant system point to the use of the tax mechanism. The "feeling" that donors will respond more favorably to a tax mechanism than to a direct system does not appear sufficiently grounded in supportable factual evidence to warrant foregoing the advantages that a direct system offers.

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Footnotes

1. For arguments that a substitute for the charitable contributions deduction should not mirror the deduction system—and that many of the "virtues" listed for the deduction are in fact defects—see Gerard M. Brannon and James Strnad, "Alternative Approaches to Encouraging Philanthropic Activities," paper prepared for the Commission on Private Philanthropy and Public Needs.

2. A proposed matching grant system was set forth initially in Paul R. McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute For The Income Tax Deduction," 27

Tax L. Rev. 377 (1972), which in turn was an expansion of an earlier paper, McDaniel, "An Alternative to the Federal Income Tax Deduction in Support of Private Philanthropy," in Tax Institute of America, *Tax Impacts On Philanthropy* 171 (1972). For criticisms of the matching grant proposal, see Boris I. Bittker, "The Propriety and Vitality of a Federal Income Tax Deduction for Private Philanthropy," in *Tax Impacts on Philanthropy*, supra, p. 145, and Bittker, "Charitable Contributions: Tax Deductions or Matching Grants?" 28 Tax L. Rev. 37 (1972).

3. The text discussion refers to cash gifts by individual living donors. The special problems created by donations of appreciated property are discussed infra, page 2460. Contributions of services by individuals are not matched since the value of such contributed services are not allowable as a deduction under present rules. The proposed system could provide for federal matching grants for volunteer services if the difficult problem of valuing those services were satisfactorily resolved.

Contributions by corporations are not matched since such expenditures should be dealt with under the tax rules generally applicable to corporate expenditures. Thus, if the expenditure is ordinary and necessary, it should be fully deductible under normal tax principles. I.R.C. §162(a). Of course, if the expenditure is capital, personal, or extraordinary in nature, tax principles would likewise disallow or defer the deduction. The present 5 percent limit on charitable contributions is inappropriate unless it is seen as a mechanical means by which Congress sought to segregate what are deductible ordinary and necessary expenditures from nondeductible capital, etc. expenditures. The advantage of the arbitrary percentage is that it eliminates disputes between taxpayers and the IRS over whether each particular contribution falls in the deductible or nondeductible category. Advisors to the commission take differing views of the function of the charitable contribution deduction in the corporate tax system. Professor Lowell Harriss' analysis corresponds to the views expressed above. On the other hand, R. Palmer Baker, in his study of corporate giving, appears to adopt the view that the charitable contributions deduction for corporations constitutes a federal expenditure program rather than a proper deduction determining corporate taxable income. See Baker, "Corporate Charitable Contributions," paper prepared for the Commission on Private Philanthropy and Public Needs, p. 1853.

4. Executive Office of the President, Office of Management and Budget, The Budget of the United States Government, Fiscal Year 1976, Special Analysis F, pp. 108-109.

5. See I.R.C. §§56-58.

6. See John P. Persons, John J. Osborn, Jr., Charles F. Feldman, "Criteria for Tax Exemption under Section 501(c)(3) of the Internal Revenue Code," paper prepared for the Commission on Private Philanthropy and Public Needs, 1975.

7. The charitable contribution deduction would be repealed for both the estate and gift taxes. The revenue gain derived from repeal of the gift tax deduction could be added either to the proposed lifetime gift system or to the proposed testamentary gift system. Estimate from Michael J. Boskin, "Estate Taxation and Charitable Bequests," paper prepared for the Commission on Private Philanthropy and Public Needs, 1974, p. 1476.

8. See Chapter VII, pp. 2500 to 2503.

9. See Chapter VII, pp. 2501 to 2502.

10. Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1976*, Special Analysis F, pp. 108-109.

11. Staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation, *Estimates of Federal Tax Expenditures* 5, 9, 10 (Comm. Print 1973) (hereinafter cited as "Federal Tax Expenditures.")

12. The settlement between the government and the taxpayer may take place on a current basis (1) if the taxpayer takes the deduction into account in computing his quarterly estimated tax liability, or (2) for those in the withholding system, under §3402(m) which allows itemized personal deductions to reduce the amount subject to withholding.

13. See Tax Analysts and Advocates, 2 Tax Notes, No. 39, p. 7 (September 30, 1974); *N.Y. Times*, "Rockefeller Lists $24-Million Gifts to Aid Charities," October 20, 1974, p. 1; 120 Cong. Rec. S 19365, October 17, 1974, (statement of Sen. Wm. L. Scott).

14. See Bentham, *The Principles of Morals and Legislation* (Hafner Library of Classics ed. 1948) pp. 112-113; Hart, *The Concept of Law* (1961), 176-78.

15. See, e.g., Hicks, *Value and Capital* (1939).

16. 1974 estimate based on 1973 law, provided by Staff of Joint Committee on Internal Revenue Taxation.

17. Ibid.

18. Federal Tax Expenditures, *supra* note 11, pp. 9, 10.

19. The figure is derived from Internal Revenue Service, Statistics of Income 1971, Individual Income Tax Returns 78-79 (1973) (hereinafter "SOI"), as modified by data in 1973 Comm'r of Internal Revenue Ann. Rep. 66.

20. Federal Tax Expenditures, *supra* note 11, pp. 9, 10.

21. 1970 SOI, p. 120.

22. Total contributions to charity in 1970 were an estimated $16.8 billion; itemized deductions constituted $13.0 billion. Feldstein, "Simulation Number 1 on September 27, 1974," prepared for the Commission on Private Philanthropy and Public Needs.

23. Ibid. A study by Allen H. Lehrman, Office of Tax Analysis, U.S. Treasury Department, made for the Commission estimated that charitable contributions in 1972 by standard-deduction individuals totalled $3.4 billion.

24. David Good and Aaron Wildavsky, "A Tax By Any Other Name: Budget Versus Tax Alternatives For Financing Government Support of Charitable Contributions," paper prepared for the Commission on Private Philanthropy and Public Needs, 1974.

25. See *infra*, pp. 2454, 2456.

26. See, e.g., Tait, *The Taxation of Personal Wealth* (1967), 2-4.

27. Simons, *Personal Income Taxation* (1938), 50.

28. For a proposal to include gifts and inheritances in income, see 3 Report of the Royal Commission on Taxation (Canada, 1966), 39-42, 465-69.

29. See Upton and Lyons, *Basic Facts: Distribution of Personal Income and Wealth in the United States* (Cambridge Policy Studies Institute, 1972). See also Smith and Franklin, "The Concentration of Personal Wealth 1922-1969" (unpublished paper presented to the American Economic Association, December, 1973); Budd, *Inequality and Poverty* (1967), xxii, Table 7; Lampman, "Changes in The Share of Wealth Held by Top Wealth-Holders, 1922-1956," 41 Rev. of Econ. & Stat. 379, 391-92 (1959); Kuznets, *Shares of Lower Income Groups in Income and Savings* (National Bureau of Economic Research, 1953), xxxv-xxxvii.

30. For a proposed flat matching grant system, see Good and Wildavsky, *supra*, note 18.

31. See, e.g., Musgrave, *The Theory of Public Finance* (1959), 98-110.

32. See, e.g., Statement of John D. Rockefeller III, in Hearings on the Subject of Tax Reform before the House Committee on Ways and Means, 91st Cong. 1st Sess. 1573 (1969) (hereinafter "1969 House Hearings").

33. Interview with John D. Rockefeller III, "Time to Give the Small Contributor a Bigger Tax Break?" Vol. LXXVI No. 14 *U.S. News & World Report* 61-62 (April 8, 1974). The proposal, which apparently would allow a charitable contribution deduction outside the standard deduction, is similar to the proposal made by the Treasury in 1968, although the Treasury also introduced a 3 percent floor. See U.S. Treasury Department, Tax Reform Studies and Proposals, House Committee on Ways and Means and Senate Finance Committee, 91st Cong. 1st Sess. 194 (Comm. Print 1969) (hereinafter "Tax Reform Proposals").

34. See Statement of Peter G. Peterson, hearings on H.R. 13270 before the Senate Committee on Finance, 91st Cong. 1st Sess. 6136 (1969) (hereinafter "1969 Senate Hearings"). See also the discussion in Chapter IV.

The proposal advanced by Mr. Rockefeller, *supra*, note 33, might avoid an *absolute* decline in receipts by higher education, museums, and symphonies because it represents an increase in the amount of total federal funds for charity. Nonetheless, his proposal would also result in a *relative* shift in federal funds to charities such as community chests and churches.

35. 1970 SOI, p. 128.

36. See 1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation* (1972), 244, for the years 1969-1971, and 1975 Supplement for subsequent years.

37. See Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969 (1970), pp. 75-89.

38. Ibid pp. 215-218.

39. Ibid pp. 224-227.

40. Prior to the 1969 changes, the maximum federal revenue loss for a contribution by a 70% bracket donor of property that had $100 in appreciation was $95, i.e., $70 from the deduction plus $25 in foregone tax on the capital gain. With the removal of the 25% alternative rate (for gains over $50,000), the federal revenue loss on the same contribution rose to $105, i.e., $70 from the deduction and $35 from foregone tax on the capital gain (70% x one half of the gain).

41. See staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Revenue Act of 1971 (1972), 50-51.

42. Under the tentative decision by the Ways and Means Committee, an additional exclusion of 1% for each year (up to 25) that an asset is held in excess of 5 years would be added to the present 50% exclusion. An overall limit on the exclusion equal to 70% of the gain would be imposed. Thus the tax on $100 of gain for a 70% bracket taxpayer qualifying for the maximum exclusion would be $21 (70% of $30). The federal share of contributing the same asset to charity would be $70 plus $21, or $91.

43. The Ways and Means Committee has tentatively approved a comparative minimum tax along the lines of that suggested by the Treasury in 1968. See Tax Reform Proposals, p. 136. For discussions of the proposed "comparative" and the present "additive" minimum tax approaches, see statement of McDaniel, in Panel Discussions on General Tax Reform Before the House Committee on Ways and Means, 93rd Cong. 1st Sess., part 6, 711-712 (1973); Surrey, *Pathways to Tax Reform* (1973), 267-277.

44. That charities need increased funds seems well established. See, e.g., The Ford Foundation, *The Finances of the Arts* (1974). That Americans would support increased federal support for charities is indicated by a survey showing that 64% of Americans would be willing to pay an additional $5 per year in taxes for support of the arts. See Associated Council of the Arts, *Americans and the Arts* (1974).

45. Harry Kahn, *Personal Deductions in The Federal Income Tax*, (1960), ch. 4.

46. Ibid, pp. 71-83.

47. 1968 SOI, p. 75.

48. Michael Taussig, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions," 20 Nat'l. Tax J. 1 (1967).

49. That is, the top marginal bracket was reduced from 91% to 70%.

50. Taussig, *supra*, note 48, p. 16.

51. Taussig elsewhere estimated that for every $1 spent by the federal government through the deduction, charities received only 5¢ in incremental donations. American Alumni Council Special Conference, Symposium: Taxation and Education (1966), 26.

52. Robert A. Schwartz, "Personal Philanthropic Contributions," 78 J. of Pol. Econ. (1970), 1264.

53. Tax Reform Proposals, *supra*, note 33, p. 194.

54. Ibid, p. 200.

55. Ibid, p. 199.

56. Brannon, *The Effect of Tax Deductibility on the Level of Charitable Contributions and Variations on The Theme* (Fund for Public Policy Research, 1974), pp. 1-26.

57. Ibid, p. 9.

58. Ibid, p. 24.

59. Martin Feldstein, "On the Effects of The Income Tax Deduction Treatment of Charitable Contributions: Some Preliminary Results," paper prepared for the Commission on Private Philanthropy and Public Needs.

60. Ibid, p. 23.

61. Ibid, pp. 15-16.

62. Ibid, pp. 33-36. At 1970 levels, Professor Feldstein estimated that repeal of the deduction would have reduced giving from $16.9 billion to $12.3 billion if unaccompanied by a tax reduction, and to $12.5 billion with a 4.1% general tax reduction. The federal revenue loss from the deduction in 1970 was $3.65 billion, so that repeal of the deduction alone would have resulted in a reduction in net private giving of $1.1 billion, or about 6.5%. Data from Feldstein, "Simulation Number 1 on September 27, 1974," *supra*, note 22.

63. Ibid. The most critical problems in Feldstein's view are the restrictions imposed by limiting the data base to itemized tax returns, the unreliability of AGI as a measure of income at high bracket levels, and the lack of data on wealth.

64. Martin Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Microeconometric Analysis," paper prepared for the Commission on Private Philanthropy and Public Needs.

65. Ibid, p. 1394.

66. Ibid, p. 1398.

67. Ibid, p. 1411.

68. Ibid, pp. 1409-11. The alternatives considered were cast in the form of a 20% tax credit and a 30% tax credit. The matching grant percentages used in the text are the equivalents of these tax credits, as calculated by Feldstein and Clotfelter.

69. The text discussion was derived from Feldstein, "Simulation Number 2 on September 27, 1974" presented to the October 4, 1974, meeting of the Advisory Committee to the Filer Commission held in Washington, D.C.

70. Meeting of the Advisory Committee to the Filer Commission, October 4, 1974, Washington, D.C.

71. Statement [illegible] Peter G. Peterson, 1969 Senate Hearings 6119. The survey mentioned was later published in Commission on Foundations and Private Philanthropy, Foundations, Giving and Public Policy (1970). See also Hunter, *The Tax Climate for Philanthropy* (1968).

72. 1969 Senate Hearings p. 6137.

73. Michigan Survey Research Center, Institute for Social Research, "Preliminary Report to the Commission On Private Philanthropy and Public Needs" (1974), Table 13.

74. 1968 SOI, p. 75.

75. See James N. Morgan, Richard F. Dye, and Judith H. Hybels, "Results From Two National Surveys of Philanthropic Activity," paper prepared for the Commission on Private Philanthropy and Public Needs. The text discussion is derived principally from material at pp. 161, 176-79, 184, 193, 231-32.

76. Brannon did not include income elasticity estimates in his study.

77. See Feldstein and Clotfelter, *supra,* note 64, p. 1412.

78. 1970 SOI, p. 128. Some 5.1% of all itemized returns gave amounts in excess of 10% of AGI; but itemized returns accounted for 24.6% of the total dollar amount of donations reported.

79. Ibid. The figure would be much larger if standard-deduction returns were included.

80. Council For Financial Aid To Education, *Voluntary Support Of Education 1969-70,* p. 12.

81. See S. 659, 92d Cong., 2d Sess. (1971); H. Rep. No. 92-1085, 92d Cong., 2d Sess. (1972).

82. Internal Revenue Code of 1954; Revenue Act of 1962; Revenue Act of 1964; Tax Reform Act of 1969.

83. P.L. 93-344. See also H. Rep. No. 93-1101, 93d Cong. 2d Sess. (1974).

84. Federal Tax Expenditures, supra note 11; 1976 Budget, Special Analysis F, supra note 10.

85. Feldstein, *supra,* note 59, p. 9.

86. Brannon, *supra,* note 56, p. 9.

87. Taussig, *supra,* note 48.

88. Council for Financial Aid to Education, Survey Data on Employee Matching Gift Programs, Research Report (February 1972).

89. General Electric Foundation, 1973 Corporate Alumnus Program 35.

90. John H. Watson III, "Employee Gift Matching Programs," The Conference Board Record 21 (June 1969).

91. Council for Financial Aid to Education, Survey Data on Employee Matching Gift Programs, Research Report 2 (February, 1972).

92. Watson, "Employee Gift Matching Programs," The Conference Board Record 21, 22 (June 1969).

93. Watson, "The Match-A Challenge to Corporate Giving," The Conference Board Record 48 (April 1969).

94. Waldemar Nielsen, *The Big Foundations* (1972), 92.

95. Watson, *supra*, note 93, pp. 48, 49.

96. Ibid, p. 50.

97. Ibid.

98. National Foundation on the Arts and the Humanities Act, 20 U.S.C. §§951-960 (1965).

99. National Endowment for the Arts, Guide to Programs 5 (1973).

100. Ibid.

101. Table 10 is derived from Feldstein, Simulation No. 2 on February 15, 1975, and Simulation No. 2 on September 27, 1974 (prepared for Commission on Private Philanthropy and Public Needs); Feldstein, supra note 59, p. 14. As has been observed, economists do not all agree with Professor Feldstein's conclusions as to the price and income elasticities of the charitable contributions deduction. Tables comparable to Table 10 using a price elasticity of 0.5 may be found in McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Deduction," 27 Tax L. Rev. 377, 401 (1972).

102. Ibid. The slight variation in total giving reflected in Table 11 (from $18.1 billion under the tax system to $18.0 billion under the DMG system) is believed to result from mechanical assumptions adopted for purposes of the computer simulation. Professor Feldstein's analysis of the tax system assumed that all gifts were made on a "first dollar" basis, i.e., that donors do not consider the fact that a gift may drop them to a lower tax bracket and hence increase their cost. Under the DMG system the deduction is eliminated so that the actual price of gifts by donors can be estimated. In any event the variation between the two totals is why 0.5%, so that it can be safely disregarded for policy-making purposes.

103. Table 12 is derived from Feldstein, Simulation No. 2 on September 27, 1974, *supra*, note 101.

104. Internal Revenue Service Statistics of Income 1966, Individual Income Tax Returns 75 (1968).

105. See generally, Rudick and Gray, "Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity," 16 Tax L. Rev. 273 (1961).

106. I.R.C. §170(e).

107. See 1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation* (1972), 940-941.

108. See U.S. Treasury Department, Tax Reform Studies and Proposals, House Ways and Means Committee and Senate Finance Committee, 91st Cong., 1st Sess. 331 (Comm. Print 1969).

Reliance by charities, especially colleges and universities, on the present tax rules for gifts of appreciated property seems singularly ill-advised. The present tax rules on gifts of appreciated property are attacked even by those who favor the charitable contributions deduction as such (Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harv. L.Rev. 309, 371-372 (1972)). Moreover, reliance on gifts of appreciated property produces a double economic loss to charitable organizations when there is a downturn in stock prices: one, the value of their own portfolios falls; two, gifts are deferred or eliminated as donors wait for stock prices to rise. Wall Street Journal, "Doubl Trouble: Endowment Funds During Slump Give Colleges Twin Woes," Vol. 187, No. 7, November 29, 1974, p. 1, Col. 8.

109. Treas. Reg. §§1.1001-1(e) and 1.1015-4. Presumably, the special allocation of basis rule prescribed by §1011(b) would be inapplicable if the charitable contributions deduction were repealed.

110. The crucial problem for charitable organizations is thus whether the gain on the property transferred is subject to tax. But this issue is present under the deduction system and is neither aggravated nor alleviated by the direct matching grant system. It has frequently been asserted, however, that education would be hurt relatively greater than other charities if the rules on gifts

of appreciated property were changed. Professor Feldstein's studies indicate that this is not so. Of the amount of reduced giving resulting from taxing the gain, education would absorb almost 15% whereas religion would absorb about 22%.

Under either the deduction system or the direct matching grant system, gifts to charity in the form of appreciated property can be expected to decline somewhat if the gain is taxed. Using various price and income elasticities and gain/value ratios, Professor Feldstein estimated a decline in donations of such gifts ranging from $257 million to $542 million *if no matching grant incentive were substituted for the change in tax treatment.* At 1972 levels, this reduction would have amounted only to 1.3-3% of total giving. See Feldstein, Simulation No. 4, 12-14 on November 9, 1974, prepared for Commission on Private Philanthropy and Public Needs. Use of a direct matching grant system would, of course, reduce or eliminate the shortfalls estimated by Professor Feldstein.

111. Feldstein, "Taxes and Charitable Contributions: Differences in the Impact of Alternative Tax Policies on Religious, Educational and Other Organizations," paper prepared for the Commission on Private Philanthropy and Public Needs, pp. 2-3.

112. Feldstein, Simulation No. 3 on November 9, 1974 prepared for the Commission on Private Philanthropy and Public Needs.

113. The tables are from Lehrman, "A Survey of Charitable Contributions by Individuals," paper prepared for the Commission on Private Philanthropy and Public Needs, October 1974. Tables 10, 11 and 12. See also Statement of Peter G. Peterson, Hearings on H.R. 13270 before the Senate Comm. on Finance, 91st Cong., 1st Sess. 6118, 6136 (1969); American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.* (various years).

114. Lehrman, *supra* note 113, Table 7.

115. Feldstein, Simulation Number 1 on November 9, 1974, "Summary of Gifts by Donee," prepared for the Commission on Private Philanthropy and Public Needs.

116. Table 17 is taken from Feldstein, Simulation No. 2 on February 15, 1975, prepared for the Commission on Private Philanthropy and Public Needs.

117. Tables 18 and 19 are derived from data in Feldstein, Simulation No. 2 on February 15, 1975, prepared for the Commission on Private Philanthropy and Public Needs.

118. See Council for Financial Aid to Education, *Voluntary Support of Higher Education 1973-74*, p. 5. See also Levi and Steinbach, *Patterns of Giving To Higher Education II: An Analysis of Voluntary Support of American Colleges and Universities, 1970-71* (American Council on Education).

119. Council for Financial Aid to Education, *supra*, note 118, p. 8.

120. Feldstein, supra note 115, "Simulation Number 2."

121. See Simons, *Personal Income Taxation* (1938), 50. The amount of the federal matching grant itself should not be included in the income of the donor. Although the donor has a power over the federal funds that power is a limited one and the donor is actually operating as the agent of the federal government in allocating its appropriations for charitable organizations. Under normal tax rules, an agent is not taxed on income that is in fact that of his principal, even though the income passes through the agent's hands. See, for example, *Carver* v. *United States*, 412 F.2d 233 (Ct. Cl. 1969). In this respect, the proposed matching grant is like the campaign contributions check-off system whereby Congress has designated taxpayers as its agents to allocate federal campaign financing funds to the political parties of their choice.

122. Conference with personnel in office of Assistant Commissioner (Planning and Research, Research Division), Internal Revenue Service, on May 16, 1974.

123. 33 Social Security Bulletin, April, 1970) p. 1.

124. Rev. Rul. 70-217, 1970-1 Cum. Bull. 12.

125. L. Bixby, "Income of the People Aged 65 and Older: Overview from 1968 Survey of the Aged," 33 Social Security Bulletin 3 (April, 1970) p. 11.

126. Ibid at 6.

127. Ibid at 8 (Table 1).

128. See Ibid p. 5 for a complete definition of the sources of income.

129. Ibid p. 11 (Table 3).

130. Ibid p. 12 (Table 4).

131. Ibid p. 13 (Table 6)

132. 1970 United States Census, Table 94, pp. 1-398.

133. I.R.C. §213.

134. Evidence of this bunching tendency can be demonstrated alegebraically by the following equations. The proposed percentage matching grant (%MG) can be approximated as a linear function of the percent of income donated (%ID):

(a) $\%MG = 5\,(\%ID)$ for $\%ID$ greater than 1%. The dollar amount of federal funds thus triggered can be calculated as:

(b) $$\begin{aligned} \$MG &= \%MG\,(D) \\ &= [5(\%ID)]\,(D) \\ &= [5(D/INC)]\,(D) \\ &= \frac{5D^2}{INC} \end{aligned}$$

where D = dollar value donated
%ID = percent of income donated
INC = Income

For example: For a given income of $10,100

Donation	$D	%ID	%MG
1	$ 100	1%	5%
2	500	5%	25%
3	1,000	10%	50%

From the above numbers it is easily seen that donation #2 of $500—a fivefold increase over donation #1—triggers a grant that is 25 times larger than MG #1. When the gift is then doubled in line 3, the $ match is quadrupled, and so forth. In sum, the $ amount of the MG increases at a faster rate than dollars donated, thereby fostering an incentive to bunch donations.

135. This effect can also be seen algebraically by the following equation:

When $\%MG =$ constant (C), $\$MG + \%MG(D) = (C)\,(D)$, a linear relationship between federal dollars triggered and dollar amount donated.

136. Holt, "Averaging of Income for Tax Purposes: Equity and Fiscal Policy Considerations," 2 Nat'l. Tax J. 349 (1949).

137. Ibid p. 352.

138. In the IRS conference, *supra* note 122, a preference was expressed for no averaging device because of the data storage problems involved. However, if an averaging device were necessary, then the IRS preference is for a system that requires storage of only one number.

139. I.R.C. §6033.

140. In 1973, there were 664,586 tax-exempt organizations, of which more than 220,000 qualified as recipients of deductible charitable contributions.

141. Conference, *supra* note 122.

142. Ibid.

143. According to the 1973 Annual Report of the Commissioner of Internal Revenue, Table 23 at page 145, the total obligations of the Internal Revenue Service amounted to $1.16 billion. With a total of 117 million returns filed, the average cost per return is approximately $10.

144. In 1973 there were 22 million filers who used Form 1040A. There are an estimated 15-17 million non-filers (Computed by using the tables and charts in Statistics of Income, 1971, Individual Income Tax Returns, pp. 4, 5, 80, and the 1970 Census Statistics on total population).

145. Ibid, p. 66.

146. Conference, *supra* note 122.

147. 1973 Comm'r. Rept. *supra* note 143, p. 145.

148. One estimate has placed the amount of overreporting under the present deduction system at 20% of the purported contributions itemized on income tax returns. Taussig in American Alumni Council Special Conference, Symposium: Taxation and Education 26 (1966).

149. Revenue Act of 1916, ch. 463, 39 Stat. 756.

150. The gift tax was first introduced on the floor of the House. See 65 Cong. Rec. 3119-3120 (1924). After receiving the House bill, the Senate Finance Committee recommended its elimination, mainly on the grounds that it would be impossible to enforce because individuals making gifts often occupy "confidential relationships" with each other and the revenue received would be far outweighed by the cost of enforcing the law. (S. Rep. No. 398, 68th Cong., 1st Sess. (1924)). The Senate did not follow the advice of the Finance Committee, though, and kept the gift tax, amending its rates and exemption. The Conference Committee accepted the House's version of the tax, along with some of the Senate amendments (H.R. Rep. No. 844, 68th Cong., 1st Sess. 8,27 (1924)). See 65 Cong. Rec. 3120, 3170, 8095 (1924). The gift tax was repealed in the period 1926-32 and then reinstated. See Revenue Act of 1932, S.Rep. No. 605, 72nd Cong. 1st Sess. (1932).

151. I.R.C. §2033.

152. I.R.C. §§2501(c), 2511.

153. Revenue Act of 1918, ch. 18, §403(a)(3), 40 Stat. 1057.

154. See, H.R. Rep. No. 708, 72nd Cong., 1st Sess. 8, 27-31, 49 (1932).

155. Surrey, *Pathways to Tax Reform* (1973), 89.

156. See, e.g., Lowndes and Kramer, *Federal Estate and Gift Taxes* (1956), 350; Paul, *Federal Estate and Gift Taxation,* Vol. 1 (1942) 645. The Senate Finance Committee in 1954 added qualified veterans groups to the list of organizations that a person could make a bequest to and receive a deduction on his estate tax. The sole purpose for this addition was to "encourage bequests to those organizations devoted to promoting the welfare of the veterans." S. Rep. No. 1622, 83d Cong., 2d Sess. 125 (1954).

157. Assumes an unmarried decedent and disregards all deductions except the $60,000 exemption.

158. See Internal Revenue Service, Statistics of Income 1969, Personal Wealth, Estate Tax Returns (1973). The study is discussed in McNees, Deductibility of Charitable Bequests, 26 Nat'l Tax J. 79, 87-89 (1973).

159. Ibid. The basic information to be determined is how much the government lost in estate tax revenues because of the charitable deduction.

160. See e.g., McNees, *supra*, note 158.

161. Boskin, Estate Taxation and Charitable Bequests, Memorandum No. 180 (November 1974) prepared for the Commission on Private Philanthropy and Public Needs.

162. Ibid, pp. 49-51.

163. According to this schedule, a wealthy estate (any estate over a 50% effective tax bracket) will never be able to trigger the highest match, even if its entire estate after taxes is given to charity. In order to reach the maximum match (83%) the amount going to charity must be greater than 50% of the donation base. But the donation base will include the amount of estate tax paid. If more than 50% of the estate is paid in taxes, then it would be impossible for this estate to bequeath 50% or more to charity. The estate tax returns were listed according to the size of the total assets of the estate before deductions and the $60,000 exemption. Because of this, it was impossible to ascertain how many estates had a taxable estate that fell into any one estate group. For example, if an estate had total assets of between $400,000-$500,000, it was impossible to say what the taxable estate was as it is conceivable that the estate had a taxable estate of anywhere from 0 (because of deductions of $500,000) to $500,000 (this would not take into consideration any lifetime transfers, either gifts in contemplation of death or incomplete lifetime transfers that were included in the estate). Despite these problems, it was possible to compute an estimated revenue loss. The method used was to take the aggregate amount of taxable estates for each grouping and divide by the number of returns in that group. This figure gave what the average taxable estate size of each estate was in this group.

The same procedure was followed with respect to the charitable deduction. That is, the aggregate amount of charitable bequests for that estate asset group was divided by the number of returns in that group that made bequests to charities. This figure gave the average charitable bequest made by each decedent who made a bequest. This figure was added onto the average net taxable estate and the amount of tax which would have been due on this size estate was computed. SOI gave the aggregate amount of tax paid by each estate group, so that by dividing that figure by the number of returns for each group, the average amount of tax paid by each estate in that group could be determined. The average amount of tax that would have been due if the charitable deduction had not been taken could likewise be calculated, thus giving the average amount of tax lost for each estate that took a charitable deduction. By multiplying this average tax loss by the total number of estates that made bequests to charities within this estate group, one could compute the total tax loss for that group. Because the aggregate amount of charitable transfers in that group was given, the true cost of the bequest to the decedent could then be calculated.

It is possible that the aggregate amounts of lost tax revenue for the government are actually understated. In taking an average of the charitable deduction for each group, tax loss was kept to a minimum. For example, if there are two equal-sized estates with a total charitable deduction of 10 between them, the way to calculate the smallest amount of government revenue loss is to take an average, that is, to say that each estate took a deduction of 5. Any other combination (e.g. one estate deducts 8 and the other 2) will result in a greater tax revenue loss because of the progressive tax rates.

One problem that could misstate the government revenue loss was the use of the average net taxable estate. It was known for each group what the aggregate amount of taxable estate was, and how many returns fell into this group. These two figures gave the average net taxable estate for that group. To the extent that the charitable bequests, in reality, came from those estates that were larger than this average estate, the revenue loss will be understated because the revenue loss was calculated at the average (lower rate) estate bracket.

The government tax loss could be overstated if nearly every charitable bequest was made by net estates that were below this average net estate for that group. This appears unlikely because there is a direct relationship between the size of the estate and the amount of charitable bequests (see Shoup, *Federal Estate and Gift Taxes* (1966), Appendix B, p. 155). Basically, the relationship is that as the estate size increases so do the amount of funds transferred to charity, in which case the revenue loss would be understated. Furthermore, even if there is an equal distribution between above- and below-average estates, the government loss will be understated because of the progressive brackets. The rationale behind this schedule is that the wealthy estates are handled adequately by virtue of the large amount of federal dollars they will control because of the dollar size of their bequests.

If it is felt necessary to allow larger estates to reach the maximum match, an alternative schedule could be used which would allow to ever estate, regardless of its size, the ability to trigger the maximum match:

Percent of Total Estate Donated	*Matching Federal Grant As Percent of Donation*
0-3%	8.3%
3-6	16.6
6-9	24.9
9-12	33.2
12-15	41.5
15-18	49.8
18-21	58.1
21-24	66.4
24-27	74.7
27-30	83.0

The effect of this schedule is to allow an estate the right to trigger the highest match if it bequeathed 30% or more of its adjusted gross estate to charities.

164. The additional expenses incurred by the I.R.S. will result from handling those returns that have net assets under $60,000 (which previously did not have to be filed) that have made charitable bequests and from checking all returns that have made charitable bequests to ascertain what charities have been designated. This should not involve a great deal more work because only 12% of the total number of estates that filed returns in 1973 made charitable bequests. See Sunley, *infra*, note 165, p. 5.

165. Emil M. Sunley, Jr., "Dimensions of Charitable Giving Reported on Federal Estate, Gift, and Fiduciary Tax Returns," paper prepared for the Commission on Private Philanthropy and Public Needs, November 1974, p. 2326.

166. Ibid.

167. Several changes in the estate and gift tax area in the Tax Reform Act of 1969 reduced tax benefits available through the charitable deduction. See Staff of Joint Committee on Internal Revenue Taxation, *General Explanation of Tax Reform Act of 1969* (1970), pp. 75-88. In addition, various current proposals for additional changes would further reduce the impact of the tax deduction. See, e.g., Westfall, "Revitalizing the Federal Estate and Gift Taxes," 83 Harv. L. Rev. 986 (1970).

168. I.R.C. §§2036-2038.

169. I.R.C. §2035.

170. I.R.C. §2012.

171. I.R.C. §170(b)(1)(A)(i).

172. I.R.C. §170(c)(2)(B). Similar provisions are set forth in I.R.C. §2055(a)(2) and §2522(a)(2). For convenience, the text discussion of constitutional issues refers throughout to the income tax deduction and to the proposed matching grant system for lifetime transfers. The discussion is, however, equally applicable to the estate and gift tax deductions and the proposed matching grant system for testamentary transfers.

173. *Walz* v. *Tax Comm'n*, 397 U.S. 664, 668 (1970).

174. Hammett, "The Momogenized Wall," 53 A.B.A.J. 929, 936 (1967).

175. Ibid.

176. It is well established that the Fourteenth Amendment has made applicable to the states the limitations of the First Amendment. See *infra*, note 243.

177. *Everson v. Board of Education*, 330 U.S. 1, 16 (1947). Jefferson, in a letter to Baptists of Danbury, Connecticut states: "I contemplate with sovereign reverence that act of the whole American people which declared that the legislature should 'make no law respecting an establishment of religion or prohibiting the free exercise thereof', thus building a wall of separation between church and state." 16 Writings of Thomas Jefferson 281-82 (1903).

178. Howe, *The Garden and the Wilderness* (1965).

179. Katz, *Religion and the American Constitution* (1963).

180. Hammett, *supra*, note 174, p. 929.

181. See, e.g., Kauper, *The Constitutionality of Tax Exemptions Accorded American Church Property* (1963); Kauper, "The Supreme Court and The Establishment Clause: Back to *Everson?*," 25 Case W. L. Rev. 107 (1974).

182. Howe, *supra*, note 178, pp. 5-10.

183. Ibid, pp. 6-7, 9-11.

184. Katz, *supra* note 179, p. 9. Howe does not agree with this position although he finds it credible. Howe, supra note 8 at 22.

185. 1 Annals of Cong. 434 (June 8, 1789) (1834).

186. Ibid, p. 731 (August 15, 1789).

187. Ibid, p. 766 (August 20, 1789).

188. Journal of the First Session of the United States Senate 128 (1820).

189. Katz, *supra*, note 179, p. 9.

190. 330 U.S. at 31-32, where Justice Rutledge, dissenting, wrote that the policy objective is "to create a complete and permanent separation of spheres of religious activity and civil authority by comprehensively forbidding every form of public aid or support for religion."

191. 413 U.S. 756 (1973).

192. Ibid, p. 760.

193. 403 U.S. 602 (1971).

194. Ibid, p. 614.

195. Quoted in Pfeffer, *Church, State, and Freedom* (1953), 478.

196. 28 Journals, Cont. Cong. 293-5 (April 23, 1785).

197. 33 Journals, Cont. Cong. 400 (July 23, 1787).

198. 343 U.S. 306 (1952).

". . . The First Amendment, however, does not say that in every and all respects there shall be a separation of Church and State. Rather, it studiously defines the manner, the specific ways, in which there shall be no concert or union or dependency one on the other. That is the common sense of the matter. Otherwise the state and religion would be aliens to each other—hostile, suspicious, and even unfriendly. Churches could not be required to pay even property taxes. Municipalities would not be permitted to render police or fire protection to religious groups. Policemen who helped parishioners into their places of worship would violate the Constitution. Prayers in our legislative halls; the appeals to the Almighty in the messages of the Chief Executive; the proclamations making Thanksgiving Day a holiday; 'so help me God' in our courtroom oaths—these and all other references to the Almighty that run through our laws, our public rituals, our ceremonies would be flouting the First Amendment. A fastidious atheist or agnostic could even object to the supplication with which the Court opens each session: 'God save the United States and this Honorable Curt'." Ibid, pp. 312-13.

199. 333 U.S. 203 (1948).

"It seems clear to me that the 'aid' referred to by the Court in the *Everson* case could not have been those incidental advantages that religious bodies, with other groups similarly situated, obtain as a by-product of organized society. This explains the well-known fact that all churches receive 'aid' from government in the form of freedom from taxation. The *Everson* decision itself justified the transportation of children to church schools by New Jersey for safety reasons. It accords with *Cochran* v. *Louisiana State Board of Education*, 281 U.S. 370, where this Court upheld a free textbook statute of Louisiana against a charge that it aided private schools on the ground that the books were for the education of the children, not to aid religious schools. Likewise the National School Lunch Act aids all school children attending tax-exempt schools. In *Bradfield* v. *Roberts*, 175 U.S. 291, this Court held proper the payment of money by the Federal Government to build an addition to a hospital, chartered by individuals who were members of a Roman Catholic sisterhood, and operated under the auspices of the Roman Catholic Church. This was done over the objection that it aided the establishment of religion. While obviously in these instances the respective churches, in a certain sense, were aided, this Court has never held that such 'aid' was in violation of the First or Fourteenth Amendment." Ibid at 249-50 (footnotes omitted).

"The practices of the federal government offer many examples of this kind of 'aid' by the state to religion. The congress of the United States has a chaplain for each House who daily invokes divine blessings and guidance for the proceedings. The armed forces have commissioned chaplains from early days. They conduct the public services in accordance with the liturgical requirements of their respective faiths, ashore and afloat, employing for the purpose property belonging to the United States and dedicated to the services of religion. Under the Servicemen's Readjustment Act of 1944, eligible veterans may receive training at government expense for the ministry in denominational schools . . .

"In the United States Naval Academy and the United States Military Academy, schools wholly supported and completely controlled by the federal government, there are a number of religious activities. Chaplains are attached to both schools." Ibid at 253-54 (Footnotes omitted).

200. Kauper, *supra*, note 181, p. 127.

201. 43 D.C. Code §43-1533 (1967).

202. Servicemen's Readjustment Act of 1944, Ch. 268, 58 Stat. 289.

203. *Terrett* v. *Taylor*, 9 Cranch 43, 49 (1815).

204. Howe, The Constitutional Question, Religion and the Free Society 57 (Fund for the Republic 1958).

205. 330 U.S. 1, 18 (1946).

206. Ibid.

207. 333 U.S. 203 (1948).

208. 343 U.S. 306 (1952).

209. 366 U.S. 420, 421 (1961).

210. 367 U.S. 488 (1961).

211. 370 U.S. 421 (1962).

212. 374 U.S. 203 (1963).

213. Ibid, p. 222.

214. 374 U.S. 398 (1963).

215. 392 U.S. 236 (1968).

216. 393 U.S. 97 (1968).

217. 397 U.S. 664 (1970).

218. Ibid, p. 674.

219. 403 U.S. 602 (1971).

220. 403 U.S. 602 (1971).

221. 403 U.S. 672 (1971). This case represented the first occasion on which the Supreme Court upheld direct financial aid from government sources to private religious institutions.

222. *Wolman* v. *Essex*, 342 F.Supp. 399 (S.D. Ohio 1972), aff'd 409 U.S. 808 (1972): "[E]ntanglement . . . has now been formally made a part of the tripartite Establishment Clause test." Ibid, p. 410.

223. 403 U.S. at 612-13 (citations omitted). Subsequent Supreme Court cases involving the Establishment Clause have not revised the quoted formula. See *Committee for Public Education and Religious Liberty* v. *Nyquist*, 413 U.S. 756, 93 S.Ct. 2955 (1973); *Wheeler* v. *Barrera*, 417 U.S. 402, 94 S.Ct. 2274 (1974); *Meek* v. *Pittenger*, 95 F.Ct. 1753, 43 U.S.L.W. 4596 (1975).

224. 403 U.S. at 615.

225. Implicit in the text statement is the acceptance of the proposition that the income tax deduction for charitable contributions constitutes a tax preference intended to aid charities rather than a structural provision of the Code intended to help define net income. Congress, from the inception of the deduction in 1917, has viewed the deduction as a means of providing financial assistance to charity. This view has been reiterated as changes in the deduction have been effected.

For example, when the then 15% limit on the charitable deduction was increased in 1952, the Senate Finance Committee Report stated that "most needed relief will be given to colleges, hospitals, and other organizations who are becoming more and more dependent upon private contributions to enable them to balance their budgets and carry on their programs . . . Your committee believes that it is to the best interest of the community to encourage private contributions to these institutions." S. Rep. No. 1584, 82nd Cong. 2d Sess. 2 (1952). A further increase in the limit in 1954 was justified "to aid these institutions in obtaining the additional funds they need." S. Rep. No. 1622, 83d Cong. 2d Sess. 29 (1954). In 1969, the limit was increased to 50% "to strengthen the incentive effect of the charitable contributions deduction." Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969 at 75 (1970).

Most recently, the deduction for charitable contributions was listed by the House Ways and Means Committee as a "tax expenditure" in "Estimates of Federal Tax Expenditures" Prepared by the Staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation (June 1, 1973) pp. 5, 9-10, and in United States Budget, 1976, *infra*, note 246.

See also the discussion at page 2500, for an analysis of why the charitable deduction is not a structural component in a normative income tax, and Chapter VI, for a discussion of why the charitable contribution deductions in the estate and gift taxes likewise constitute tax expenditures within a transfer tax system.

226. 397 U.S. 664 (1970).

227. Ibid, pp. 674-75 (footnute omitted).

228. Ibid, p. 704.

229. See also *McGlotten* v. *Connally*, 338 F. Supp. 448 (D.D.C. 1972) where, in a case involving a Black citizen's claim that granting a federal income tax exemption (with corresponding deductibility of contributions) to a racially segregated organization was unconstitutional, Judge Bazelon stated:

"We think there is little question that the provision of a tax deduction for charitable contributions is a grant of federal financial assistance within the scope of the 1964 Civil Rights Act. 'The charitable contribution deduction is a special tax provision not required by, and contrary to, widely accepted definitions of income applicable to the determination of the structure of an income tax.' It operates in effect as a Government matching grant and is available only for the particular purposes and to the particular organizations outlined in the Code. We see no difference between the provision of Federal property 'at a consideration which is reduced . . . in recognition of the public interest to be served by such sale or lease to the recipient,' and a tax deduction in the form of a matching grant provided for contributions to causes deemed worthy by the Internal Revenue Code.'" Ibid at 462 (footnotes omitted), citing Surrey, Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance, 84 Harv. L. Rev. 352, 384 (1970).

230. 413 U.S. 756, 93 S.Ct. 2955 (1973). See Kauper, *supra*, note 181, for a discussion of the case.

231. 350 F. Supp. 655 (S.D.N.Y. 1972).

232. 93 S.Ct. at 2974-75 (citation omitted). See also *Murray v. Comptroller of the Treasury*, 241 Md. 383, 216 A. 2d 897 (1966).

"Indubitably, religious organizations benefit from the [property tax] exemption. Economically, they are in the same position as though they paid taxes to the city and state and then received back the amounts paid in the form of direct grants. Moreover, members of the general public pay higher taxes than they would if the exemptions were not in effect; the same amount of revenue must be raised and, by reason of the exemption, the rate paid by non-exempt taxpayers is higher." Ibid, pp. 399, 906.

233. 93 S. Ct. at 2975.

234. Ibid, pp. 2,975-76.

235. Ibid, p. 2,976.

236. Ibid. In upholding the constitutionality of a state program to lend secular testbooks to private school students, the Court in *Meek v. Pittinger, supra*, note 223, emphasized the fact that the state lending program extends to "all schoolchildren, those in public as well as in private schools." Compare *Public Funds for Public Schools v. Marburger*, 358 F. Supp. 29 (D.N.J. 1973), aff'd. 417 U.S. 961 (1974), where public school children were *lent* books but parents of private school children were *reimbursed* for the *purchase* of books, the latter program being held unconstitutional.

237. Ibid.

238. Ibid, p. 2,974, n. 49.

239. See Aaron, "Federal Encouragement of Private Giving," in Tax Institute of America, Tax Impacts on Philanthropy 211 (1972).

240. For a helpful discussion of these points, see Comment, Tax Incentives as State Action, 122 U. Pa. L. Rev. 414 (1973). It must be recognized, however, that some lower courts have appeared to take more literally the Court's language in *Walz* about tax exemptions and have come very close to espousing the view that tax exemptions for religious organizations are constitutionally permissible because they are tax exemptions, rather than because, after being subjected to the constitutional tests applicable to direct-aid programs, they satisfy the applicable constitutional prerequisites. See, e.g., *Marker v. Connally*, 485 F.2d 1003 (D.C. Cir. 1973); *Junior Chamber of Commerce of Rochester v. The United States Jaycees*, 495 F.2d 883 (10th Cir. 1974).

241. Simons, Personal Income Taxation (1938). Simons distinguished expenditures which he identified as "consumption" and which were not considered as deductions in reaching taxable income and other "non-consumption" expenditures which were deductible. While this line may be a difficult one to draw in practice, Simons clearly recognized it in theory. Ibid, p. 54.

242 See Surrey, *Pathways to Tax Reform* (1972), 3-18.

243 See Comment, Tax Incentives as State Action, 122 U. Pa. L. Rev. 414 (1972) for a discussion of the legislative history of the charitable deductions; see also note 225, *supra*.

244 See S. Rep. No. 91-552, 91st Cong., 1st Sess., 1969-3 Cum. Bull. 423, 473.

245 See Congressional Budget Act of 1974, P.L. 93-344, H. Rep. No. 93-1101, 93rd Cong. 1st Sess. (1974); and "Estimates of Federal Tax Expenditures", *supra*, note 225.

246 See Annual Report of the Secretary of the Treasury on the State of the Finances for Fiscal Year 1968, 326; Executive Office of the President, Office of Management and Budget, Budget of The United States Government, 1976, Special Analysis F, p. 108-109.

247 338 F. Supp. 448 (D.D.C. 1972). See also *supra*, note 229.

248 330 F. Supp. 1150 (D.D.C. 1971), aff'd without opinion sub nom. *Coit v. Green*, 404 U.S. 997 (1971).

249 309 F. Supp. 1127 (D.D.C. 1970).

250 333 F. Supp. 662 (E.D. Wis. 1971).

251 See, e.g., Statement of Peter C. Peterson, Chairman, Commission on Foundation and Private Philanthropy, Hearings before the Senate Finance Committee on the Tax Reform Act of 1969, 91st Cong., 1st Sess. 6119, 6135 (1969).

252 Bittker and Kaufman, "Taxes and Civil Rights: 'Constitutionalizing' the Internal Revenue Code," 82 Yale L.J. 51, 64 (1972). For an extensive criticism of the Bittker position, see Comment, *supra*, note 243.

253 The protection would presumably be achieved technically by denying standing to sue on the basis of *Massachusetts v. Mellon*, 262 U.S. 447 (1923).

254 This view would apparently subject provisions that are clearly income-defining to constitutional challenge which is as erroneous as totally insulating *all* tax provisions from such scrutiny.

255 Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harv. L. Rev. 309 (1972).

256 Ibid., p. 345, n. 64.

257 Under Simons' definition of income as "increase in net worth" plus "consumption" in any given period, the function of "consumption" is simply to serve as a summary of the non-deductible, i.e. non-business related, expenditures made in the period. Andrews attempts to give the concept of "consumption" an independent content based on a distinction between public goods and private goods. He, however, concedes that this interpretation really goes in the direction of shifting from an *income* tax to a *consumption* tax, in which case his definitional problems in determining what constitutes "consumption" would be significant.

258 For an analysis of Professor Andrews' position, see Surrey, *Pathways to Tax Reform* (1973), pp. 20-21, 288-89.

259 The standing requirements vary depending on whether the claimed violation is of the Free Exercise or the Establishment Clause. See Bittker and Kaufmann, "Taxes and Civil Rights: 'Constitutionalizing' the Internal Revenue Code," 82 Yale L.J. 51, 54 (1972) ("[I]n applying the First Amendment, the Supreme Court has distinguished between the Free Exercise Clause, which can be invoked only by a person whose right to worship has been infringed by the action complained of and the Establishment Clause, which can be enforced by a broader circle of persons."); Moore, "The Supreme Court and the Relationship Between the 'Establishment' and 'Free Exercise' Clauses," 42 Texas L. Rev. 143, 147 (1963).

The plaintiff in Establishment Clause cases is not seeking to enjoin collection of his own taxes (I.R.C. §7421; *Enochs v. Williams Packing and Navigation Co.*, 370 U.S. 1 (1962)), but is challenging the use to which the tax funds are put. See *Flast v. Cohen*, 392 U.S. 83 (1968); *Green v. Kennedy*, 309 F. Supp. 1127 (D.D.C. 1970); *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972); *Eastern Kentucky Welfare Rights Organization v. Schultz*, 370 F. Supp. 325 (D.D.C. 1973).

These cases impose the requirement that the plaintiff must establish that he was injured in fact by the invalid law or administrative action and that the injury was to an interest protected by the constitutional provision allegedly violated by the law or action. See also *Sierra Club v. Morton*, 405 U.S. 727 (1972); *United States v. Students Challenging Regulatory Agency Procedures*, 412 U.S. 169, 93 S.CT. 2405 (1973); *Association of Data Processing Service Organizations v. Camp*, 397 U.S. 150 (1970); *U.S. v. Richardson*, 42 U.S.L.W. 5076 (1974); *Schlesinger v. Reservists Committee to Stop the War*, 418 U.S. 208 (1974). The important point is that the standing tests are the same whether the financial aid is provided through the tax system or directly.

260. Information supplied by U.S. Treasury Department.

261. See Persons, *et. al.*, *supra*, note 6.

262. It is not self evident that the defintiion of "charity" must necessarily include "religion". The English Statute of Charitable Uses enacted in 1601 did not (applying only to the "repair of churches"). But by 1891, charity for purposes of the English income tax included the advancement of religion. Commissioners v. *Pemsel*, L.R. App. Cas. (1891). This broader classification was assumed to be correct by the majority in *Nyquist*, as quoted on pp. 2498-99.

263. 93 S.Ct. at 2976.

264. *Walz v. Tax Comm'n*, 397 U.S. 664, 697 (1970) (footnote omitted).

265. Tax Institute of America, Tax Impacts on Philanthropy 223 (1972).

266. American Association of Fund-Raising Counsel, Inc., *Giving U.S.A.* 1973, estimated the lower figure. Professor Feldstein's studies for the Filer Commission are the basis for the higher estimate. Professor Feldstein's estimate is likely to be more accurate since the *Giving U.S.A.* estimate appears to have markedly underestimated giving by standard deduction donors.

267. 93 S.Ct. at 2966.

268. According to Professor Felstein's study for the Commission, churches in 1970 received an estimated $10.4 billion out of $17.3 billion contributed to all charities. However, federal funds made available by the deduction accounted for only $3.4 billion of this latter amount. Of this $3.4 billion, I estimate that roughly $2.2 billion went to churches. Thus 62% of the federal funds go to religious organizations. This estimate is derived from the data on the distribution of charitable gifts by donor AGI classes discussed in Chapter III and by type of donee, discussed in Chapter IV. It must be kept in mind that churches engage in many non-sectarian activities; hence only some unknown portion of the estimated $2.2 billion in federal funds received by religion in 1970 was actually expended for sectarian purposes.

269. 93 S.Ct. at 2971.

270. Ibid.

271. 374 U.S. 203, 301-302 (1963) (footnotes omitted).

272. 93 S.Ct. at 2970-71 *n.* 38; see also *supra*, note 236.

273. 413 U.S. 734, 743-743, 93 S.Ct. 2868, 2874 (1973) (citations omitted).

274. 330 U.S. 1, 16 (1946).

275. The Court in *Meek v. Pittinger*, *supra*, note 223, found that a state program of lending secular institutional material to public schools was unconstitutional under *Lemon v. Kurtzman* and *Nyquist*.

276. *Kosydar* v. *Wolman*, 353 F.Supp. 744, 752 (S.D. Ohio, 1972), *aff'd* 413 U.S. 901, 93 S.Ct. 3062 (1973):

"Since the primary purpose of a statute can rarely be successfully challenged in court, the tripartite *Lemon* test will, almost invariably, be deemed satisfied or violated by examining the relationship of the primary effect of the given statute to its potential for entanglement."

277. Supra, note 222.

278. The original income tax act of 1913 did not provide for any deduction for charitable contributions. In the second Revenue Act of 1917 an amendment was introduced in the Senate from the floor by Senator Hollis which would have permitted deductions of up to 20% of the taxpayer's taxable net income. 55 Cong. Rec. 6741 (1917). The Senate reduced this amount to 15% and then unanimously passed the amendment.

From original enactment to the present there have been several changes in the structure of the deduction. In 1918 estates and trusts were allowed the deduction, followed by corporations in 1935 (although limited to five percent). Similarly, applicable limits have fluctuated from the original 15% of taxable net income, to 20% in 1952 (adjusted gross income rather than taxable net income), to the 30% limitation of 1954 (with unlimited deductions in certain special cases), to the 50% aggregate of a taxpayer's contribution base for the taxable year set by the Tax Reform Act of 1969. See generally, Taggert, "The Charitable Deduction," 26 Tax L. Rev. 63 (1970).

There has been a generally parallel trend with regard to tax rates so that the percentage limitations on charitable deductions have been liberalized as income tax rates have increased. Of this trend, Professor Rabin wrote:

"The result of these two movements, extending over some fifty years, has been to increase very gradually, but very substantially, the government's 'share' of a charitable contribution. In 1919 an unmarried taxpayer earning $50,000 per year could receive a maximum income tax benefits of $2,295 or charitable contributions. Today's maximum for the same taxpayer is $8,730 [by rates applicable in 1966]. Thus, from its modest beginnings, the extent of governmental 'encouragement' for charitable giving has increased substantially."

Rabin, "Charitable Trusts and Charitable Deductions," 41 N.Y.U.L. Rev. 912, 917 (1966) (footnote omitted).

The reduction in tax rates in 1964 and the increases in the standard deduction in 1969 and 1971 had the effect of reducing the federal contribution to charity. See Chapter II.

279. See, e.g., Statement of William P. Thompson, Associated General Counsel, National Conference of Churches of Christ, in Senate Finance Committee Hearings on Tax Reform Act of 1969, 91st Cong. 1st Sess. 2086 (1969).

280. *Walz* v. *Tax Commission*, 397 U.S. 664, 675 (1970).

281. Ibid, pp. 675-678.

282. *Committee for Public Education and Religious Liberty* v. *Nyquist*, 413 U.S. 756, 93 S.Ct. 2955, 2976-78 (1973). *Meek* v. *Pittinger*, *supra*, note 223, followed *Nyquist* and *Earley* v. *DiCenso*, *supra*, note 219, in holding that there was an impermissible degree of entanglement in a state program that supplied public school professional staff, and supporting materials, to sectarian private schools for "secular, neutral, non-ideological" auxiliary services such as counseling, speech therapy, etc.

283. See also Freund, "Public Aid to Parochial Schools," 82 Harv. L. Rev. 1680 (1969): "While political debate and division is normally a wholesome process for reaching viable accommodations, political division on religious lines is one of the principal evils that the first amendment sought to forestall." Ibid, p. 1692.

284. *Bradfield* v. *Roberts*, 175 U.S. 291 (1899). See also *Abernathy* v. *City of Irvine*, 355 S.W. 2d 159 (Ky. Ct. App. 1961) cert. denied, 371 U.S. 831 (1962).

285. *Everson* v. *Board of Education*, 330 U.S. 1, 16 (1946) (emphasis omitted).

286. 374 U.S. 203, 242 (1963).

287. 330 U.S. at 18.

288. 397 U.S. at 676.

Part VI

Property Tax

THE EXEMPTION OF RELIGIOUS, EDUCATIONAL, AND CHARITABLE INSTITUTIONS FROM PROPERTY TAXATION

L. Richard Gabler† and John F. Shannon†

Summary of Findings

- Although data are scarce and not entirely reliable, several studies support the conclusion that the amount of tax-exempt property of all types—government and private—is large and growing. Assuming that one third of all property is exempt, as suggested by these studies, approximately $15 billion of local property tax revenues is shifted from tax-exempt to taxable property. Of this $15 billion, some $10 billion can be traced to the exemption of government property and $5 billion to the exemption of private holdings.

- There is wide variation among states in the types of religious, educational, and charitable activities that are accorded tax-exempt status. Only churches, nonprofit cemeteries, and charities are exempt in all 50 states and the District of Columbia.

- Tax exemption is advocated as an appropriate government subsidy to foster the provision of services and activities that are largely "public" or social in character. The unique features of this approach are its permanence and the virtual assurance of freedom from governmental intervention.

- Critics of the exemption technique score the fact that this approach bypasses the governmental budget procedure and lacks flexibility to meet changes in social priorities. Also condemned are the severe inroads that exempt property can make into the tax base of local governments and the very imprecise measuring of costs and benefits.

- In large part, public concern over the tax-exempt property question can be traced to hostility to the property tax, the continued increases in this tax, and the greater availability of information on exempt property. Nonetheless, this hostility has not led, in general, to an organized, action-oriented program by public interest groups against the tax-exempt property practice.

- Although few advocate wholesale repeal of existing property tax exemptions, support can be found for various fiscal alternatives. State reimbursement to localities for state-mandated exemptions would resolve the conflict that occurs when one governmental level pays for exemptions granted by another. This approach would not alter the value of the exemption to the recipient institution and could, at least potentially, be adapted to meeting equalization objectives among localities.

- The imposition of local service charges or voluntary payments by tax-exempt institutions would erode the value of tax exemption. These alternatives would recover only a part of the revenues foregone by tax exemption and would not constitute the equivalent of placing such institutions back on the property tax rolls.

- In addition to fiscal alternatives, several adminstrative reforms would serve to tighten-up the exemption technique. Among the most important are (1) periodic or annual renewal of exemption by the state government to assure the tax-exempt institution is performing the services for which the exemption was granted; (2) regular assessment of tax-exempt property and publication of findings; and (3) local home rule in granting exemptions, accompanied by state safeguards.

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I

CURRENT MAGNITUDES AND TRENDS

The exemption of religious, educational, and charitable institutions from property taxation has existed from "time out of mind." The question of tax-exempt property and its impact on the local tax base has not lacked attention. The Advisory Commission on Intergovernmental Relations investigated this issue in 1963; numerous states and localities have also conducted or commissioned studies relating in whole or in part to the amount of exempt property, its ownership, its use, and the trend of taxable to tax-exempt realty.

Despite the continual interest in the topic, there is a paucity of current, comparable data on tax-exempt property for the nation as a whole, for states, and for localities within particular states. The reason for this is not hard to find: Tax-exempt property, by definition, produces no governmental revenue. Because much of the tax-exempt property is of a unique or special nature, the cost of assessing and updating valuations has proven difficult to justify. As one study noted: "It is no secret that most tax exempt property is assessed at unrealistically low figures. Knowing that the property will produce no revenue, assessors frequently just drive past it and make what the trade knows as a "windshield evaluation," rather than spend valuable time making an accurate assessment."[1]

While there is a general lack of statistical data, several studies, using various estimating techniques, have been made of the value of exempt property at the national, state, and local government levels, both over time and at a given point in time. This section of the study summarizes the findings of selected earlier analyses of the amount of tax-exempt property and trends in this area, presents more recent data for selected states on the value of tax-free property in both the aggregate and for religious, educational, and charitable institutions taken together, and presents a 50-state tabulation of the taxable or tax-exempt status of various religious, charitable, and educational organizations and activities.

Summary of Previous Studies

Data presented by Harold B. Meyers indicate that the pace of property tax exemptions has far outstripped the growth in the real property tax base. Using four bench-mark years and estimates of market value, Meyers estimates that tax-exempt property has grown from $2.0 billion, or 4.6 percent of all real property, in 1880, to $20.5 billion, or 11.7 percent of all real property, in 1922, to $294.7 billion, or 23.4 percent, in 1961, and to $569.5 billion, or 32.6 percent, in 1968.[2] Compared with a forty-fold increase in the value of real property between 1880 and 1968, the value of property tax exemptions has grown 285 times.

Meyers' estimation that tax-exempt property accounts for one third of all real property is generally in line with the findings of other studies. For example, Leo A. Droste, using Census Bureau data, estimated a $600 billion price tag for tax-exempt property out of a total market valuation of $1.8 trillion.[3] Similarly, Alfred Balk found an average ratio of exemptions to total real property values of 35 percent for the 1967-1969 period in selected major cities.[4] Estimates by Joan E. O'Bannon, generally centering on the year 1964, show the ratio of exempt land, including government property, to total assessed value to range from 5.48 percent in Arizona to 168.81 percent in Oregon. The comparable ratio for exempt private property in 19 states ranged from .53 percent in Idaho to 74.58 percent in Louisiana (see Table 1).

Table 1

Total Assessed Value of Taxable Property in Selected States in Relation to Value of All Tax-Exempt Property and of Tax-Exempt Private Property (in billions of dollars)

State	Year	Total Assessed Value of Taxable Property	Total Exempt Land, Including Government Property		Exempt Private Property	
			Value	Percent of Total Assessed Value	Value	Percent of Total Assessed Value
Alabama	1964	$ 3.59	$ n.a.	—	$ .79[a]	22.01
Arizona	1964	2.19	.12	5.48	n.a.	—
California	1964	36.74	26.65		7.12	19.38
Colorado	1964	3.92	.76	19.39	.12	3.06
Connecticut	1961	9.80	2.30	23.47	1.01	10.31
Florida	1964	13.83	n.a.	—	4.95[b]	35.79
Georgia	1964	5.02	n.a.	—	1.18[c]	23.51
Idaho	1964	.76	n.a.	—	.004[d]	.53
Indiana	1964	6.26	n.a.	—	1.03	16.45
Louisiana	1964	4.13	n.a.	—	3.08[e]	74.58
Maine	1963	2.34	1.02	43.59	.21	8.97
Maryland	1964	12.50	2.50	20.00	n.a.	—
Massachusetts	1963	11.57		—	1.78	15.38
Minnesota	1962	7.32	1.37	18.72	n.a.	—
Mississippi	1963	1.69	n.a.	—	.04	2.37
Nevada	1964	1.30	n.a.	—	.07	5.38
New Jersey	1963	24.10	4.00	16.00	n.a.	—
New York	1963	46.27	18.10[g]	38.12	3.30	7.20
Ohio	1963	19.97	3.07	15.37	1.03	5.16
Oklahoma	1964	3.34	n.a.	—	.53[h]	15.87
Oregon	1964	3.11	5.25	168.81	.55	17.68
Pennsylvania	1957	12.50	2.80	22.40	1.24	9.92
Washington	1964	3.84	1.00	26.04	.20	5.21

n.a. - not available.

a. Includes only homesteads and industrial factories and plants.

b. Includes only homesteads.

c. Includes only homesteads and personal property.

d. Includes only the real property for veterans, the blind, and widows.

e. Includes only homesteads and manufacturing plants.

f. Includes only some private nonprofit, district, and county property.

g. Includes Indian and foreign lands.

h. Includes only homesteads and personal property.

Source: Joan E. O'Bannon, "Payments from Tax Exempt Property" in Property Taxation, U.S.A., Richard W. Lindholm, ed. (The University of Wisconsin Press, 1967), p. 205.

Additional evidence on the magnitude and trends in tax-exempt property valuations is available at the local level. For all Maryland counties, tax-exempt property was 28.9 percent of all taxable property in 1969-1970; in Baltimore City, the comparable figure was 33 percent; statewide, this averaged out to just under 30 percent.[5] For Baltimore, it is also clear that exempt values have increased as a share of total taxable real estate in each year since 1966. Similar findings are shown for New York State: Exempt Valuations as a proportion of total real estate valuations have increased between selected bench-mark years from 1894 to 1965, with virtually no interruptions. Statewide, the ratio of exempt to total valuations increased from 13.2 percent in 1894, to 22.6 percent in 1950, to 25.6 percent in 1957, and to 29.8 percent in 1965.[6] The comparable figures for New York City were 16.2 percent, 24.5 percent, 28.6 percent, and 33.0 percent. Outside New York City, the figures show the same pattern of increase: 10.9 percent in 1894, 19.0 percent in 1950, 20.6 percent in 1957, and 23.8 percent in 1965. Richmond, Virginia, data demonstrate the pattern once again. With only a few interruptions, and these of minor importance, the ratio of tax exempt to total real estate valuations has increased, from 15.0 percent in 1955 to 23.1 percent in 1973.[7] Although available at only one point in time, data for Milwaukee, Wisconsin, indicate that over 35 percent of the personal property and real estate within the city is exempt from taxation.[8]

Thus, sketchy and incomplete as the data may be, there is a pattern that emerges from these several studies. They all support the conclusion that whether attention is focused at the national, state, or local government level, the value of tax-exempt property has been increasing more rapidly than the value of taxable property. Equally significant, reasonably current magnitudes for some states and for individual localities, in particular, are of substantial size. While O'Bannon's study shows a considerable variation in the ratio of exempt to total assessed valuations on a statewide basis, among the selected states examined, several other studies have settled on an approximate figure of one third as the ratio of exempt to total valuations.

Exempt Property in Selected States

As noted earlier, magnitudes relating to the value of exempt property are not only scarce, they are also suspect. Local assessors frequently feel that exempt property is not worth the time and effort to arrive at current valuation and hence the property is carried for another year or assessment period at its previous value, however determined. To give at least some feel for the magnitude, Table 2 presents U.S. Bureau of the Census data on exempt property. These data cover 17 states and the District of Columbia. The Census material was supplemented by data obtained from individual state reports for 15 additional states. To assure a greater degree of comparability among states, the value of tax-exempt religious, charitable, and educational institutions was aggregated rather than tabulated individually for each classification as was done in the Census and state reports.

For these jurisdictions, the value of all exempt property—including that owned by federal, state, and local governments—is frequently in excess of 20 percent of the total state assessed value. For the aggregate of religious, educational, and charitable exemptions, the comparable ratio is frequently in the 5 to 10 percent range. Clearly, no great confidence can be placed in these figures since the data are not uniform in quantity or quality. Yet, these data, inadequate as they are, do lend credence to the estimates of previous studies and help to support the conclusion that the value of all tax-exempt property can make substantial inroads into the tax base traditionally relied upon by local governments.

Table 2

Tax-Exempt Property and Comparative Data, Selected States, 1971 (in millions of dollars)

State	Total Assessed Value	Assessed Value of: Exempt Property, All Types	Assessed Value of: Religious, Educational, Charities	Ratio of All Exempt Property to Total Assessed Value	Ratio of Religious, Charitable, and Educational Property to Total Assessed Value
Arizona[a]	$ 3,693	$ 759	$ 86	20.6	2.3
California[b]	53,931	3,822	1,480	7.1	2.7
Connecticut[c]	14,881	3,533	1,925	23.7	12.9
Delaware[c]	1,838	21		1.1	
District of Columbia	8,419	4,480	370	53.2	4.4
Florida	55,377	18,043	2,710	32.6	4.9
Georgia	10,329	1,569		15.2	
Hawaii	8,764	3,443	358	39.3	4.1
Idaho[c]	923,314	5,531		0.6	
Indiana[d]	14,756	5,348		36.2	
Iowa[c]	7,042	123		1.7	
Kansas[d, e]	5,394	402		7.5	
Louisiana	9,628	6,815	851	70.7	8.8
Maine[c]	4,169	50		1.2	
Maryland	22,206	3,942	1,984	17.8	8.9
Massachusetts	28,510	6,762	2,105	23.7	7.4
Minnesota[c]	3,960	965	437	24.4	11.0
Mississippi[c]	1,926	606		31.5	
Nebraska[c]	4,181	73		1.7	
Nevada[f]	2,693	863	66	32.0	2.5
New Hampshire[c]	4,546	40		0.8	
New Jersey[g]	49,618	8,383	1,703	16.9	3.4
New Mexico[c]	2,148	224		10.4	
New York	88,716	28,241	7,575	31.8	8.5
North Dakota[c]	627	2		0.3	
Ohio	35,919	4,960	2,711	13.8	7.5
Oklahoma[c]	3,488	522		15.0	
Oregon	27,563	9,664	1,240	35.1	4.5
Pennsylvania	21,067		2,181	11.7	10.3
Rhode Island	6,537	1,429	417	21.9	6.4
South Dakota[h]	3,274	1,004	296	30.7	9.0
Vermont[c]	1,414	23		1.6	
Wyoming[c]	1,156	5		0.4	

a. Excludes charitable type of totally exempt property.
b. Excludes governmental totally exempt property.
c. Totally exempt property types not reported.
d. Excludes religious, educational, charitable and governmental types of totally exempt property.
e. Excludes partial exemptions.
f. Excludes charitable types of totally exempt properties.
g. Excludes educational types of totally exempt properties.
h. Exempt property values are for the year 1969 while the taxable values are for 1971.

In some instances data are not shown because there were no totally exempt values or because the aggregates involved were not identified in reported data.

Sources: Rountree and Associates, Real Property Tax Exemptions and Relief: A Study of Policies, Practices and Impact on the Commonwealth of Virginia, Vol. 1, pp. 23-4; U.S. Bureau of the Census, 1972 Census of Governments, Taxable Property Values and Assessments - Sales Price Rates, Part 1, Connecticut, Pennsylvania, and Maryland valuation data on exempt property from state tax reports.

Table 3

Tax-Exemption Status of Religious, Educational, and Charitable Organization Categories by State

	Church	Parsonage	Cemeteries			Eleemosynary Insts.	Veteran Orgs.
			Profit	Non-profit	Future Expansions		
Alabama	x	x	-	x	x	x	x
Alaska	x	x	x	x	-	x	x
Arizona	x	-	-	x	x	x	-
Arkansas	x	-	-	x	-	x	-
California	x	x	-	x	x	x	x
Colorado	x	P. T.	x	x	-	x	x
Connecticut	x	x	-	x	x	x	x
Delaware	x	x	x	x	x	x	x
Dist. of Col.	x	x	-	x	-	x	x
Florida	x	x	-	x	-	x	x
Georgia	x	x	x	x	x	x	-
Hawaii	x	x	-	x	-	x	-
Idaho	x	x	-	x	-	x	x
Illinois	x	x	x	x	-	x	-
Indiana	x	x	-	x	-	x	x
Iowa	x	x	-	x	-	x	x
Kansas	x	x	x	x	-	x	x
Kentucky	x	x	-	x	-	x	-
Louisiana	x	-	-	x	-	x	-
Maine	x	x	-	x	-	x	x
Maryland	x	x	-	x	-	x	x
Massachusetts	x	x	-	x	x	x	x
Michigan	x	-	-	x	-	x	-
Minnesota	x	x	-	x	-	x	-
Missouri	x	x	x	x	-	x	-
Mississippi	x	x	-	x	-	x	x
Montana	x	x	-	x	-	x	-
Nebraska	x	x	-	x	-	x	x
Nevada	x	x	-	x	-	x	x
New Hampshire	x	x	x	x	-	x	x
New Jersey	x	x	-	x	x	x	x
New Mexico	x	-	-	x	-	x	x
New York	x	x	x	x	x	x	x
North Carolina	x	x	-	x	-	x	x
North Dakota	x	x	x	x	-	x	x
Ohio	x	-	-	x	-	x	-
Oklahoma	x	-	-	x	x	x	-
Oregon	x	-	x	x	x	x	-
Pennsylvania	x	-	-	x	-	x	-
Rhode Island	x	-	-	x	-	x	-
South Carolina	x	x	-	x	-	x	-
South Dakota	x	x	x	x	x	x	x
Tennessee	x	x	-	x	-	x	x
Texas	x	x	-	x	-	x	x
Utah	x	-	-	x	-	x	-
Vermont	x	x	x	x	x	x	x
Virginia	x	x	-	x	-	x	x
Washington	x	x	-	x	-	x	x
West Virginia	x	x	-	x	x	x	-
Wisconsin	x	x	x	x	x	x	-
Wyoming	x	x	x	x	x	x	x
Total	51	39	15	51	16	51	31

Source: Rountree and Associates, Real Property Tax Exemptions and Relief, Vol. 1, pp. 11-12.

x = tax exempt.

Table 3 (Continued)

	Educational								
	Fraternities								
Fraternal	Off Campus	On Campus	Hous. Facs.	Inc. Prod. Prop.	Bus. Colls.	Labor & Prof. Assns.	YMCA's & YWCA's	Retirement Homes	Total
x	x	x	-	x	x	-	x	x	13
-	-	x	x	-	-	-	x	-	9
-	-	-	x	-	x	-	-	-	6
-	-	x	x	-	-	-	-	-	5
-	-	-	x	-	-	-	x	x	9
x	x	x	x	-	x	-	x	x	12
-	-	-	x	-	-	-	x	-	8
-	-	-	-	-	-	-	x	x	9
-	-	-	x	-	-	-	-	x	7
x	x	x	x	x	-	x	x	-	12
-	x	x	x	x	x	-	x	-	12
-	-	-	x	-	-	x	-	-	6
x	x	x	x	-	x	x	x	-	12
-	x	x	x	-	-	-	-	x	9
x	x	x	x	-	-	x	x	x	12
x	x	x	x	x	x	-	x	x	13
x	-	-	x	-	-	-	x	x	10
-	x	x	x	x	x	-	-	-	9
-	-	-	-	-	-	-	-	-	3
x	x	-	x	-	x	-	x	-	10
x	-	x	x	-	-	-	x	-	9
x	-	-	x	-	-	-	x	-	9
-	-	-	-	-	-	-	-	-	3
-	-	-	x	-	-	-	x	x	7
-	-	-	x	-	x	-	x	-	8
x	x	x	x	-	-	x	x	x	12
-	-	x	-	-	-	-	-	-	5
x	x	x	x	x	x	-	-	-	11
x	x	-	-	-	-	-	x	-	8
x	-	-	-	-	-	-	x	-	8
x	-	x	x	-	-	-	x	-	10
x	-	-	-	-	-	-	-	-	5
x	-	-	x	-	x	-	x	-	11
x	x	x	x	x	-	-	x	-	11
x	x	x	x	x	-	x	x	x	14
-	-	-	x	x	-	-	x	x	7
-	x	x	x	x	x	-	-	-	9
-	-	x	x	-	-	-	x	-	8
-	-	-	-	-	-	-	-	-	3
-	-	-	-	-	-	-	-	-	3
-	-	-	-	-	-	-	-	-	4
x	-	-	x	x	x	x	x	-	13
-	-	-	x	-	-	x	x	-	8
x	x	x	x	-	x	-	x	-	11
-	-	-	-	-	-	-	-	-	3
x	x	x	x	-	x	-	x	-	13
-	-	-	x	-	-	x	x	x	9
-	x	x	x	-	x	-	x	x	11
-	-	-	x	-	x	-	-	-	7
x	-	-	x	-	-	x	x	x	11
x	x	x	x	-	x	-	x	x	14
24	20	24	39	11	18	10	34	17	

Types of Exemptions for Religious, Educational, and Charitable Organizations

The phrase "religious, educational, and charitable organizations" covers a multitude of potential activities. The types of organizations providing such services and their taxable status in the various states and the District of Columbia are presented in Table 3. While churches, nonprofit cemeteries, and charitable organizations, as categories, are exempt in all states, there is rather wide difference among states with respect to the taxable status of various organizations and activities related to religious, educational, and charitable services.

A rather generous policy of granting exemptions for religious, educational, and charitable activities prevails in North Dakota and Wyoming—which exempt 14 of the 16 classifications presented—and in 10 other states, where at least 12 of the 16 categories enjoy tax-free status. At the other end of the spectrum, 11 states have a relatively stringent tax exemption policy: Louisiana, Michigan, Pennsylvania, Rhode Island and Utah exempt only three of the categories; South Carolina, four; Arkansas, Montana, and New Mexico, five; and Arizona and Hawaii, six.

II

THE PROPERTY TAX EXEMPTION DEBATE

The Case For Exemptions

The public finance standard for evaluating a tax instrument is a broad tax base capable of providing large amounts of revenue at relatively low rates. This standard, then, implies that the tax instrument contains few, if any, exceptions to the general rate of tax and, in this sense, possesses a high degree of tax neutrality. Such a tax standard, however, collides head-on with the legislator's desire to provide special tax treatment for favored groups, activities, and individuals.

Certainly a good deal of today's property tax exemptions reflect the desire to make the property tax a more "humane" tax. It is this objective—to utilize this local revenue-producing mechanism to promote certain social purposes—that has led to the granting of exemptions for institutions and organizations such as churches, charities, schools, hospitals, all of which are viewed within our society as worthy of encouragement. The tax exemption promotes a pluralistic approach to the provision of various services that would otherwise drift into the governmental domain. As such, the tax exemption may, though it need not, relieve governments of burdens greater than the value of the tax exemption itself.

To tax religious, educational, and charitable institutions would go against the vague, but deeply ingrained, feeling that such institutions are "unsuitable" activities for the purpose of taxation. The recipients of tax-exempt status provide a benefit in return: the fostering of desirable activities and the enhancement of moral and civic values. To the extent that such activities provide "public" benefits—benefits to society as a whole, over and above those that accrue to the individual recipient—then an even stronger case can be made for government subsidization. Governmental assistance can be justified on the basis that in the absence of such public sector support there would be under-consumption of the service in question, and, since such services are presumed to confer benefits to society as a whole, this would have a detrimental effect on social well-being. The prime justification for granting property tax exemptions, then, is that the recipient institutions provide public benefits and thus are worthy of public support.

Underpinning this argument and with special reference to religious, educational, and charitable exemptions is the belief that these organizations provide services that the private sector alone would not produce, either at all or in sufficient quantity. In the absence of private sector production, government would be forced to provide these services. Even if viewed as an appropriate public sector activity, government production of these services would, of course, necessitate the imposition of the government's taxing authority. Rather than taxing such organizations and then appropriating the funds for the support of the activities, the public sector provides a subsidy by granting a tax exemption. While the subsidy need not be equivalent to the costs of providing the services, government, by exempting from tax those organizations that are willing to provide the desired public services, is promoting charitable and educational aims—and, in this case, by not invoking its powers of taxation. Professor Kendrick states this argument:

> The exemption of the property of private schools, colleges, universities, art galleries, museums, and other cultural institutions, and of churches, charitable organizations, and hospitals is commonly held to be justified by the public nature of their services. They are said to do what should be done, but what the government alone can do only imperfectly, or incompletely, if at all. . . . In a word, institutions of this character find their reason for being in the fact that the concept of public services is broader than that of the services provided by government and financed by taxation.[9]

Since the exemption is generally not subject to annual review, there is no need for recipients to appear before legislative committees, and, consequently, there is little opportunity to exert political influence or pressure on the private organizations receiving the exemption. At a minimum, officers of such organizations will not be required to court legislative approval of their activities or to have these activities channelled in directions other than those of their choosing. As one study of property tax exemptions granted to universities concluded:

> The most important of these (advantages) is the freedom afforded private educational institutions from interference by state officials. Furthermore, whatever advantages or drawbacks there may be to the exemption, as a practical matter it is politically secure.[10]
>
> On the other hand, the property tax as a mechanism for providing a public subsidy to private universities has been justified as superior to direct payments because it frees the university from political interference via budgetary control, thereby encouraging diversity and experimentation in the public-supported sector. Furthermore, the exemption insures continuity of public support, thus facilitating long-range planning. These arguments are buttressed by general principles of academic freedom. Educational institutions should be free from direct governmental control to enable them to fulfill their role as independent critics of government action.[11]

An added advantage of the property tax exemption is the low-visibility status of this mechanism which provides a greater degree of *financial certainty* to recipients than would an annually appropriated direct subsidy. (It should be noted that in some situations, direct appropriation may not be a viable alternative form of subsidy. In the area of religious activities, for example, the property tax exemption may be the only feasible instrument of governmental assistance since the direct-appropriation technique would presumably be challenged on the grounds that it violates the principles of church-state separation.)

In sum, then, the property tax exemption is a governmental subsidy which, when appropriately applied, encourages institutions providing services or activities that are public or quasi-public in character—services and activities that in the absence of a private sector counterpart, the government would have to provide. The signal advantages of this type of subsidy are the high degree of protection against governmental interference afforded to recipients and the financial certainty. Like other techniques of governmental assistance that might be used for the same purpose, the property tax exemption promotes a pluralistic society by encouraging voluntarism, recognizing that the governmental sector does not do everything best and that greater government involvement in the regulation and financing of private sector programs leads to a dimunition of discretionary freedom of private sector organizations.

The Case Against Exemptions

The same characteristics of the tax-exemption technique that are praised by its defenders are seized upon by its critics. While admitting that greater financial certainty is provided by this approach, critics point out that it is purchased at an excessive cost. In their view, the property tax exemption, just because it is "hidden," violates the principles of good government by subverting the full disclosure of what is, in effect, a public expenditure program.

If recipients are to be granted preferential tax status, this decision, the critics argue, should be made openly and, equally important, periodically. Indeed, it is the permanence of the exemption that limits the options available to government policy makers since it reduces their flexibility in adjusting to current circumstances. An organization or activity deemed worthy of an exemption at any one point in time may not necessarily be so evaluated in 5 or 10 years. Yet, many exemptions last far longer than that since nothing is harder to retrieve than a preferred tax status.

Arguments such as these imply a preference for a more "open" mechanism of government assistance, a mechanism that also allows more flexibility in accommodating changes in priorities among the competing demands placed upon governmental decision makers.

While the property tax exemption may provide considerable protection against political interferences, it does not rule out the possibility of abuse by the recipient. The exemption is in fact a subsidy, and it can be argued that the recipient should not be immune from public scrutiny since it is using public funds to provide its services.

On efficiency grounds, the property tax exemption is also vulnerable in that it is an inflexible method of support and one that bears no inherent relationship either to the recipient's ability to finance the service provided or to society's need for the service. It would be sheer coincidence if the value of the tax exemption were to match the value of an appropriation based on actual needs for the service in question. Under a direct grant, there is at least the potential for approximating these needs on a year-to-year basis. Measures of public needs are admittedly imprecise, but they would seem to be more accurate than a value that results from a determination of land and improvements valuation and the prevailing local property tax rate. Commenting on this point, one recent study concluded:

> Exempt property receives a subsidy, the value of which is the tax bill the property would otherwise have paid. An exemption is a very crude

> instrument of public policy since the amount is merely a function of the market value of the property and the effective tax rate. There is no consideration of the social worth of the service performed by the exempt organization. Consequently, the exemption subsidy may be more or less than this amount.[12]

With respect to university property tax exemptions, it has been stated:

> One difficulty with distributing public moneys in this manner is that it is a crude means for ascertaining the proper size of the subsidy. The exemption fixes the subsidy at the level of a university's hypothetical tax bill, that is, the property tax bill that would be due if the university were not exempt from taxation. The appropriate level of subsidy, however, absent redistribution goals, equals the value of public benefits that the university bestows upon the state and city in which it is located. Since the hypothetical property tax is a function of factors largely unrelated to the level of educational activity, the property tax relief enjoyed by the university will only accidentally be of comparable magnitude to the benefits it bestows.[13]

As a mechanism of providing preferred tax treatment, the property tax exemption is further criticized because it reduces the tax base, necessitating the imposition of higher rates on the remaining taxable property to secure equivalent revenues. Thus, the standard of a broad-based tax applied at a uniform rate is eroded, as is the standard of tax neutrality. Moreover, the higher rates applied to the property remaining on the tax rolls means that it is the owners of the taxable property that in effect pay for the exemption. Increased rates can also serve to raise the level of tax consciousness and taxpayer resistance, which affects what local government can do, and they influence the decisions of individuals and businesses about where to locate.

It should be emphasized that once embarked on an active exemptions policy, cumulative—and deleterious—effects can be set in motion. Granting an exemption from the property tax for one worthy cause invites similar claims from other groups stressing the worthiness of their particular interests. As such claims proliferate, it becomes increasingly difficult to draw the line against these interests. Demands for tax-exempt status are likely to increase not only because of the apparently "favorable" legislative attitude but also because the value of a property tax exemption increases as tax rates are raised to cover both the demands placed on the taxing authority and the revenues foregone by previously granted tax exemptions. The cumulative effect can be large and, to the extent such a snowballing process is set in motion, a substantial erosion of the tax base can result.

The above arguments against property tax exemption are applicable regardless of the particular recipient of the preferred tax treatment. That is, they are considerations that should enter the decision of those determining whether an exemption should be granted, regardless of the particular activity that is seeking the exemption. There is a wide variety of arguments offered against property tax exemptions that focus not on the mechanism but on the purpose for which the exemption is secured. For example, certain tax-exempt enterprises compete directly with taxpaying businesses. This occurs when the recipient of the exemption undertakes activities that have a private sector counterpart or offer goods or services that are a close substitute for the output of the private business sector. In these cases—such as municipal parking lots, cafeterias, and restaurants run by governmental or charitable organizations—the taxpaying private sector is put at a competitive disadvantage solely as the result of the tax-free status granted the competitor. While this problem is not insoluble, one real difficulty is that many exempt organizations provide a mixture of charitable and noncharitable services and measures for restricting the exemption to only those activities considered charitable simply do not exist.

III

PROPERTY TAX EXEMPTIONS: INTERGOVERNMENTAL ISSUES

From the standpoint of intergovernmental fiscal relations, the knottiest problem associated with tax exemptions centers on state government mandating an exemption from the local property tax base without providing reimbursement to local government for the property removed from the local tax rolls. This is, in effect, the same problem that arises when state governments mandate programs that local governments are required to finance from their own resources. Lacking a state reimbursement, state-mandated property tax exemptions are viewed by local officials as an infringement of local home rule and a considerable constraint on local decision-making authority.

As a more practical matter of local government finance, tax exemptions can pose severe revenue drains when exempt organizations are clustered in particular local jurisdictions. The typically hardest hit jurisdictions are the large central cities, college towns, and, at least in some states, the state capitol. Of course, a good part of the exempt property in state capitols is state owned and therefore not of direct interest to the exemption of private property. At the opposite end of the spectrum is the college town in which private property accounts for the large part of exempt property, the best-known examples being Cambridge, Massachusetts, and New Haven, Connecticut. The central city, of course, contains large amounts of both public and private property exempt from the tax rolls. Providence has 33 percent of its property in the exempt classification; Milwaukee, 25 percent; Pittsburgh, 33 percent; St. Paul, 32 percent; St. Louis, 30 percent; and Boston, 45 percent.[14]

The claim that recipients of preferred tax treatment return an equivalent benefit cannot be accepted uncritically in all instances. Even assuming that the benefit is equivalent, however, is not sufficient to establish that costs and benefits balance out within the confines of a particular jurisdiction. This is a particularly sensitive issue in the larger central cities and is one part of the question of taxation of non-residents who benefit by the use of a cluster of tax-exempt institutions located in the central city. Commenting on this point, a recent study of tax-exempt property in Hartford, Connecticut, noted:

> Non-residents of Hartford do not pay for the cost of Hartford's property tax exemptions but are free to patronize most exempt institutions. This problem is very similar to the "commuter" situation. Commuters have free use of Hartford's road system, make parking more difficult for Hartford residents, and cause traffic congestion and pollution. On the other hand, commuters spend money while in Hartford and Hartford could not maintain its position as commercial, business and cultural center of the region without them.[15]

Services of hospitals, colleges or universities, museums, and so forth, are not restricted solely to the residents of the city granting the property tax exemption; and while fees may be charged by such institutions, it seems unlikely that the fees will be—or legally could be—differentiated according to place of residence. Yet, it is the city dweller, or, more generally, the resident of the jurisdiction that grants the property tax exemption, that bears the cost. The central-city viewpoint has been summarized as follows:

> If we stop to analyze the central cities' tax exemptions, I think you will find it universally true that the central city which furnishes the appropriation or subsidy gains a small percentage of benefit for its citizenry. Hospitals, universities, and various fraternal and social groups are presumed to be of public benefit by statute, but the public benefits, if any, are metropolitan and statewide in scope. The complete subsidization, however, is limited to and provided by the central city taxpayers.[16]

While benefits spill-over mainly between the central city and metropolitan area, it cannot be ignored that such spill-overs can extend throughout the state and indeed, in the cases of a major university, federal installation, or national headquarters for an exempt institution, the nation as a whole. This concentration of tax-exempt property in the central cities is not due solely to chance or historical accident. It can be the result of deliberate zoning policies of an exclusionary nature adopted by suburban jurisdictions. As Schmit points out:

> Communities clustered outside of the city, by zoning and other devices, have effectively eliminated the poor and limited the fraternal, charitable, benevolent and other institutions from locating within their units of government. The shifting of the cost of furnishing the public benefits, whether limited or extensive, is therefore forced upon the central city taxpayer with the resultant benefits inuring to the metropolitan or statewide citizenry.

Criticisms of the property tax exemption technique cover a gamut of issues. The hallmarks of the technique—financial certainty and freedom from governmental interference—are not universally accepted as desirable. Nor can it be said that the exemption device is anything more than a crude measure of the public benefits provided by recipient institutions. By its very nature, the exemption runs counter to the ideal tax of uniform rate and broad coverage and may bestow a competitive advantage if used by recipients to provide goods and services that have a private sector analogue. Further exacerbating these drawbacks is the fact that once invoked, the property tax exemption device can snowball in importance, making serious inroads into the ability of at least some local governments to raise revenue equitably and at the same time heightening intergovernmental tensions between states and localities and among localities themselves—particularly between the central city and suburb.

Causes of Public Concern

Although critics of the property tax exemption are numerous and of long standing, they have not been noticeably successful in reversing the practice of granting tax exemption for bona-fide religious, charitable, and educational institutions and these institutions' related activities. This is not in the least surprising since the exemption practice is deeply rooted in the American experience. Yet, opponents of property tax exemption may very well have served to slow down, at least from what it might have been in their absence, the tendency to grant exemptions for certain institutions and activities. Indeed, this goal—the much greater scrutiny of potential tax exemption candidates and the careful consideration of alternative forms of public and/or private assistance to such institutions—may be the only practical objective possible; it is certainly more feasible than a mass withdrawal of granted exemptions.

It is also possible that more fundamental changes in the practice of tax exemption are obtainable, at least at certain times and in certain places. For example, the tax-exempt privilege was revoked on 159 parcels of realty in Milwaukee, Wisconsin.[17] Also indicative of this possibility are the results of a public opinion survey conducted by the Urban Observatory,[18] in which citizens in 10 selected cities (Albuquerque, Atlanta, Baltimore, Boston, Denver, Kansas City (Kansas), Kansas City (Missouri), Milwaukee, Nashville, and San Diego) were asked whether they favored or opposed removal of the tax-exempt status granted to private schools and church property. In 9 out of 10 cities, 50 percent or more of the citizens indicated they favored removing the tax exemption for private schools and in 7 of these cities, at least 50 percent favored removing the exemption for church property. As the Urban Observatory study pointed out:

> It is hard to know whether these expressions by people reflect changes in ideology over a period of time or simply a current desperation for new sources of income for cities; we do not even know whether these figures represent a change from the past. However, there seems to be little doubt that some change in the laws regarding taxation of school and church property is politically feasible in most of the cities of this country.[19]

The question of political feasibility, however, is complex. Certainly with regard to church property, constitutional questions are bound to emerge. Nor can it be said that the property tax exemption issue generally occupies a priority position in the action agenda of public interest organizations. Nonetheless, three developments suggest that public concern with the exemption issue will persist, rather than wither away. These factors are (1) the relative unpopularity of the property tax, (2) the increasing amount of property tax, (3) increased information on the types and extent of exemptions.

Unpopularity of the Property Tax

Although it is an often stated proposition that "the only good tax is the one somebody else pays," it is less well known that taxpayers differ markedly in their attitudes towards different tax instruments. Three public opinion surveys (1972, 1973, and 1974) conducted for the Advisory Commission on Intergovernmental Relations by the Opinion Research Corporation reveal that the local property tax is generally considered the "worst tax" and always one of the two least fair. When specifically asked, "Which do you think is the worst tax—that is, the least fair?" 45 percent of the respondents in the March 1972 survey singled out the local property tax, more than double the number selecting the nearest competitor among major tax instruments used by federal, state, and local governments (see Table 4). (Respondents were asked to choose between the federal income tax, state income tax, state sales tax, and local property tax.) The subsequent ACIR surveys—in May 1973 and April 1974—have shown, however, a marked diminution in taxpayer hostility to the property tax. Compared with the 45 percent figure of 1972, a respective 31 percent and 28 percent of respondents in the last two surveys reacted unfavorably to the local property tax.

Even though there was a noticeable decline in taxpayer hostility, in the 1973 survey the largest single number of respondents cited the property tax as the worst tax (one percentage point more than those selecting the federal income tax) and in the 1974 survey the property tax ranked only 2 percentage points behind the federal income tax. In contrast, there was in both of these surveys a noticeable gap between those selecting the property tax as the worst or least

Table 4

Which do You Think is the Worst Tax–That Is, the Least Fair?

1. Federal Income Tax
2. State Income Tax
3. State Sales Tax
4. Local Property Tax
5. Don't Know

	April 1974					May 1973					March 1972				
	1.	2.	3.	4.	5.	1.	2.	3.	4.	5.	1.	2.	3.	4.	5.
Total U.S. Public	30%	10%	20%	28%	14%	30%	10%	20%	31%	11%	19%	13%	13%	45%	11%
Men	29	9	22	31	10	30	9	19	34	9	19	17	15	44	11
Women	30	10	17	26	19	30	11	20	29	12	18	14	12	45	12
18-29 Years of Age	31	8	21	29	13	31	12	21	28	9	22	13	15	41	9
30-39	30	11	18	29	13	33	9	19	31	8	22	16	15	40	10
40-49	35	10	21	28	7	29	11	19	32	11	19	12	12	46	11
50-59	31	13	17	30	14	30	12	16	29	8	17	14	14	45	11
60	24	8	21	26	23	21	7	22	34	17	13	9	10	51	17
Less Than High School Completed	26	8	22	25	22	27	7	21	30	15	17	11	13	43	16
High School Completed	34	12	16	30	11	34	12	19	29	8	21	14	12	46	8
Some College	33	9	22	31	7	28	13	18	34	7	19	13	17	45	8
Professional	33	14	21	27	10	29	11	20	35	5	13	16	17	46	9
Managerial	37	10	16	29	12	37	11	16	31	5	25	12	16	41	6
Clerical, Sales	33	8	16	32	11	32	15	15	30	8	23	13	13	42	9
Craftsmen, Foremen	34	12	19	26	9	34	12	14	32	9	21	15	15	41	9
Other Manual, Service	26	10	19	31	15	32	10	24	27	10	20	13	11	43	14
Farmer, Farm Laborer	27	4	27	11	31	27	9	14	27	23	16	13	5	51	16
Non-Metro—Rural	26	8	26	18	23	32	6	17	30	15	26	9	6	41	19
—Urban	41	7	19	25	8	31	10	20	31	9	19	7	15	41	18
Metro — 50,000-999,999	30	10	17	30	15	28	13	22	28	10	18	15	14	47	7
1,000,000 or Over	27	10	21	31	14	31	9	19	33	10	15	13	14	45	13
Northeast	29	11	21	29	17	29	12	23	28	9	13	16	20	38	13
North Central	32	12	20	27	9	27	9	20	36	10	16	11	9	56	10
South	29	9	19	23	19	30	11	20	25	14	26	12	13	34	16
West	29	4	19	38	11	35	8	13	36	8	18	12	11	54	5
Under $5,000 Family Income	22	7	24	26	22	23	5	22	28	21	16	9	13	40	15
$5,000- $6,999	22	8	26	29	15	26	9	26	28	12	18	11	14	44	13
$7,000- $9,999	30	8	18	30	16	35	12	19	29	8	21	15	13	41	12
$10,000-$14,999	33	10	17	28	10	30	13	18	33	7	22	15	14	41	8
$15,000 or Over	36	14	17	27	8	34	10	16	35	6	19	13	14	46	8
White	31	10	20	29	12	30	11	19	31	10	20	12	13	45	11
Non-white	23	7	21	24	29	26	7	26	26	16	12	16	16	30	18
No Children in Household	29	9	20	28	17	28	9	20	32	12	18	11	12	46	13
With Children Under 18	31	10	19	29	12	32	11	19	29	10	19	14	15	43	10
With Teenagers 12-17	30	10	21	28	12	31	11	20	28	10	19	15	13	45	10
Own Home	31	10	18	29	13	28	12	18	35	9	19	12	12	47	11
Rent Home	27	8	24	27	17	33	7	24	23	14	19	14	15	40	12

Table 5

Here are Some of the Reasons that People Give Us for Feeling that the Property Tax is Not a Good Tax. Which One of These do You Feel is the Most Important Reason for Dissatisfaction With the Property Tax?

1. It is hardest on low income families.
2. It is based on estimates of home value that are not always fair.
3. Reassessments may sometimes result in a shocking tax bill increase.
4. It discourages homeowning.
5. It taxes any increase in the value of a home over the original purchase price, even though that increase is only on paper and not in the homeowner's hands unless he sells the house.
6. Property taxes have been going up faster than other taxes.
7. No opinion.
8. Don't agree that property tax is not a good tax.

	1.	2.	3.	4.	5.	6.	7.	8.
Total U.S. Public	27	21	6	12	12	12	11	5
Men	26	21	6	14	14	12	8	5
Women	27	21	6	10	11	12	14	4
18-29 Years of Age	24	20	5	16	13	10	11	4
30-39	20	23	8	11	19	12	9	4
40-49	25	25	8	11	14	11	8	4
50-59	29	23	8	10	10	14	10	1
60	33	16	5	9	6	12	14	9
Less Than High School Completed	32	14	5	10	7	12	17	6
High School Completed	25	23	7	15	13	13	7	4
Some College	20	29	7	10	19	10	6	4
Professional	21	23	6	13	21	9	6	4
Managerial	24	29	7	12	20	10	5	2
Clerical, Sales	22	25	8	13	14	11	8	5
Craftsman, Foreman	21	23	9	16	10	12	7	5
Other Manual, Service	29	18	6	12	10	13	15	2
Farmer, Farm Laborer	27	10	1	6	8	5	32	11
Non-Metro - Rural	25	18	4	13	8	6	23	9
- Urban	25	22	5	16	12	12	8	5
Metro - 50,000-999,999	24	22	7	11	11	12	10	6
1,000,000 or Over	29	21	7	11	14	13	9	3
Northeast	24	21	6	14	10	16	11	3
North Central	28	26	7	12	12	8	8	3
South	27	17	6	9	12	11	16	6
West	26	20	6	13	15	13	5	4
Under $5,000 Family Income	32	16	4	11	8	11	17	7
$5,000-$6,999	34	14	3	13	8	11	14	6
$7,000-$9,999	30	19	7	11	11	12	9	4
$10,000-$14,999	22	25	8	14	13	11	8	3
$15,000 or Over	19	28	7	11	18	13	6	4
White	25	22	7	12	12	12	9	5
Non-white	37	12	2	12	12	8	24	3
No Children in Household	28	20	5	10	11	13	12	5
With Children Under 18	24	22	7	13	13	10	10	4
With Teenagers 12-17	24	26	6	11	13	10	11	4
Own Home	25	24	8	10	13	13	8	5
Rent Home	30	16	3	16	10	9	16	4

Percentages add to more than 100 because multiple responses were accepted when a respondent could not decide on one reason for dissatisfaction with the property tax.

fair of tax alternatives and those citing the state sales tax and the state income tax (see Table 4).

These survey results are supported by two other studies of taxpayer attitudes towards tax instruments. When asked in a Louis Harris survey in February 1973, "From your personal standpoint, which of these taxes do you feel are too high, which too low, and which about right?" more people—68 percent—thought that the property tax was too high than any other major tax source. This represented an increase from the 62 percent registered in a similar Harris survey conducted in 1969. The results of the previously mentioned survey conducted by the Urban Observatory revealed that respondents favored the local sales tax as the method of raising additional local tax money, if needed. The local income tax was the second choice, while the local property tax placed near to or at the bottom of the list (which also included a tax on utilities and a tax on car owners).

These several studies of public attitudes towards taxes lead to the conclusion that the local property tax is a highly unpopular tax and that taxpayer consciousness is particularly acute. Among the major reasons for taxpayer discontent is the belief that the property tax hits hardest at low-income individuals and that the tax is based on estimates of home value that are not always fair (see Table 5). Other frequently cited beliefs are that property taxes have increased more rapidly than other taxes, that the property tax discourages homeowning, and that it taxes any increase in the value of a home over the original purchase price, even though that increase is only on paper and not in the homeowner's hands unless he sells the house. In this atmosphere of taxpayer hostility and sensitivity, proposals to move additional property from the tax rolls—an act that in effect requires local officials to raise the tax rates on property remaining on the tax rolls to assure an equivalent revenue yield—would, if well publicized, likely provoke further public opposition. Yet this consequence is probably not sufficient to brake the exemption movement, particularly since exemptions are incremental, possess a low-visibility status, are unrelated in time to tax rate setting, are championed by well-organized interests and at least partially supportable by the general public.

Height of the Property Tax

Hostility to the property tax rests in part on the frequently overlooked point that the property tax burden has in the recent past increased sharply and nearly continuously. At a time when virtually everyone's property tax is being hiked, proposals to remove property from the tax rolls—and further increase tax rates on non-exempt property—are bound to heighten public concern. Nor can it be ignored that higher rates, regardless of the tax instrument, tend to emphasize the inequities inherent in any particular tax source—inequities that at lower rates, may have remained within the limits of tolerance.

For the nation as a whole, the average effective property tax rate (the percentage that tax liability is of market or true value of the house) on existing single-family homes with FHA insured mortgages has increased from 1.34 percent in 1958, to 1.53 percent in 1962, to 1.70 percent in 1966, and to 1.98 percent in 1971 (see Table 6). For the entire 1958-1971 period, this amounts to a 48 percent increase in average effective property tax rates.

An increase in effective rates was registered for nearly all states in the 13-year period. The pervasiveness of the increase is readily demonstrated. For example, the number of states where the effective rate on FHA insured mortgages hit or exceeded the 2 percent figure doubled between 1958 and 1962 (from 4 to 8 states), and doubled again between 1962 and 1966; 7 states

Table 6

Average Effective Property Tax Rates, Existing Single-Family Homes With FHA Insured Mortgages, By State and Region, Selected Years 1958-1971*

State and Region	1971	1966	1962	1958
United States	1.98	1.70	1.53	1.34
New England				
Maine	2.43	2.17	1.81	1.58
New Hampshire	3.14	2.38	2.03	1.81
Vermont	2.53	2.27	2.10	1.63
Massachusetts	3.13	2.76	2.47	2.21
Rhode Island	2.21	1.96	1.93	1.67
Connecticut	2.38	2.01	1.75	1.44
Mideast				
New York	2.72	2.40	2.23	2.09
New Jersey	3.01	2.57	2.22	1.77
Pennsylvania	2.16	1.88	1.75	1.50
Delaware	1.26	1.14	.91	.71
Maryland	2.24	2.05	1.74	1.47
Dist. of Col.	1.80	1.37	1.18	1.08
Great Lakes				
Michigan	2.02	1.81	1.76	1.45
Ohio	1.47	1.44	1.24	1.07
Indiana	1.96	1.64	.96	.84
Illinois	2.15	1.96	1.79	1.35
Wisconsin	3.01	1.21	2.24	1.82
Plains				
Minnesota	2.05	2.14	1.79	1.57
Iowa	2.63	2.12	1.66	1.34
Missouri	1.79	1.64	1.36	1.12
North Dakota	2.08	1.81	1.70	1.54
South Dakota	2.71	2.64	2.31	2.01
Nebraska	3.15	2.67	1.84	1.90
Kansas	2.17	1.96	1.92	1.65
Southeast				
Virginia	1.32	1.13	1.03	.90
West Virginia	.69	.71	.79	.56
Kentucky	1.27	1.03	.94	.93
Tennessee	1.53	1.37	1.18	.97
North Carolina	1.58	1.31	1.17	.90
South Carolina	.94	.60	.53	.48
Georgia	1.44	1.30	.94	.84
Florida	1.41	1.09	.66	.76
Alabama	.85	.66	.52	.56
Mississippi	.96	.93	.76	.66
Louisiana	.56	.43	.49	.52
Arkansas	1.14	1.09	1.09	.84
Southwest				
Oklahoma	1.35	1.11	.86	.86
Texas	1.91	1.62	1.44	1.36
New Mexico	1.70	1.30	.98	.93
Arizona	1.65	2.41	2.27	2.14
Rocky Mountain				
Montana	2.19	1.70	1.58	1.32
Idaho	1.72	1.23	1.13	1.14
Wyoming	1.38	1.34	1.27	1.17
Colorado	2.45	2.20	1.85	1.72
Utah	1.49	1.52	1.31	1.05
Far West				
Washington	1.62	1.14	1.12	.92
Oregon	2.33	1.98	1.83	1.55
Nevada	1.48	1.47	1.31	1.06
California	2.48	2.03	1.71	1.50
Alaska	1.61	1.42	1.24	1.12
Hawaii	.92	.81	.77	.62

*Effective tax rate is the percentage that tax liability is of the market or true value of the house.

Source: Computed by ACIR staff from data contained in U.S. Department of Housing and Urban Development, Federal Housing Administration, Statistics Section, Data for States and Selected Areas on Characteristics of FHA Operations Under Section 203; 1971 data from unpublished FHA tabulations.

Table 7

Average Effective Property Tax Rates, Existing Single-Family Homes With FHA Insured Mortgages, 50 Largest SMSA's, By Region, Selected Years 1958-1971[a]

Standard Metropolitan Statistical Area and Region	1971	1966	1962	1958
Median of 50 SMSA's	2.13	1.95	1.71	1.42
New England				
Boston	3.21	2.70	2.46	2.24
Hartford	2.88	2.22	1.96	1.55
Providence	2.34	2.04	2.01	1.72
Mideast				
Albany	2.45	2.44	2.55	2.13
Baltimore	2.25	2.37	1.96	1.59
Buffalo	2.24	2.70	2.31	1.82
New York	2.68	2.49	2.26	2.10[b]
Newark	2.93	2.63	2.21	c
Paterson	2.53	2.30	2.02	c
Philadelphia	3.08	2.47	2.20	1.70
Pittsburgh	2.46	1.83	1.57	1.42
Rochester	2.72	2.13	1.95	1.66
Washington	1.93	1.63	1.34	1.24
Great Lakes				
Akron	1.62	1.58	1.32	1.20
Chicago	2.16	2.02	1.95	1.39
Cincinnati	1.52	1.60	1.35	1.11
Cleveland	1.88	1.62	1.39	1.23
Columbus	1.53	1.33	1.11	0.86
Dayton	1.38	1.51	1.32	1.09
Detroit	2.03	1.86	1.87	1.56
Indianapolis	2.29	2.10	1.06	0.84
Milwaukee	3.52	2.71	2.62	1.93
Toledo	1.30	1.37	1.19	0.95
Plains				
Kansas City	1.76	1.58	1.35	1.16
Minneapolis	2.08	2.16	1.82	1.67
St. Louis	2.09	1.82	1.51	1.14
Southeast				
Atlanta	1.52	1.50	1.01	0.97
Birmingham	0.98	0.84	0.68	0.66
Louisville	1.29	1.09	1.03	1.01
Memphis	1.98	1.80	1.61	1.05
Miami	1.40	1.25	0.62	0.73
New Orleans	0.48	0.38	0.55	0.53
Norfolk	1.13	0.95	0.99	0.96
Tampa	1.50	1.04	0.82	0.98
Southwest				
Dallas	1.83	1.43	1.26	1.27
Ft. Worth	2.21	1.97	1.73	1.70
Houston	1.85	1.67	1.36	1.24
Oklahoma City	1.31	1.11	0.82	0.85
Phoenix	1.62	2.58	2.36	2.18
San Antonio	2.21	1.84	1.86	1.65
Rocky Mountain				
Denver	2.45	2.17	1.86	1.69
Far West				
Anaheim	2.19	1.94	NA	NA
Los Angeles	2.85	2.17	1.71	1.44
Portland, Or.	2.28	2.01	1.77	1.58
Sacramento	2.44	2.19	1.84	1.65
San Bernardino	2.34	2.00	1.75	1.58
San Francisco	2.76	1.96	1.64	1.53
San Jose	2.61	2.12	1.85	1.62
Seattle	1.82	1.17	1.14	0.91

NA - Data not available

a. Effective tax rate is the percentage that tax liability is of market or true value of the house.

b. New York - Northeastern New Jersey.

c. Included in New York - Northeastern New Jersey.

Source: Computed by ACIR staff from U.S. Department of Housing and Urban Development, Federal Housing Administration, Statistics Section, Data for States and Selected Areas on Characteristics of FHA Operations Under Section 203; 1971 data from unpublished FHA tabulations.

were added to the list between 1966 and 1971. Thus, by 1971, some 23 states had average effective property tax rates of 2 percent or more, compared with 4 states in 1958.

The same pattern—high and steadily rising property tax rates—is apparent at the SMSA level. In the 50 largest such areas, the median effective rate has shown an uninterrupted climb—1.42 percent in 1958, 1.71 percent in 1962, 1.95 percent in 1966, and 2.13 percent in 1971 (see Table 7). Twenty-seven of the 50 largest SMSA's had effective property tax rates in excess of 2 percent in 1971. This compares with 21 SMSA's in 1966, 10 in 1962, and only 4 in 1958.

These high and rising property tax rates have served to sharpen the focus on the inequities of the property tax instrument. As is true with any tax source, the higher the rate the more difficult it becomes to grant anyone a free ride.

This is not to say, however, that the case for curbing property tax exemptions rests on a fiscal-exhaustion thesis. It cannot be claimed with any degree of assurance that local governments have suffered irreparable fiscal damage solely because of property tax exemptions. What does seem clear, however, especially in view of the uneven distribution of tax-exempt property, is that alternatives to the property tax exemption approach appear more attractive in the light of the demonstrated unpopularity of the property tax and the steady and sharp increases registered for this levy. Again, however, other considerations previously noted may override the braking effect of this factor.

Increased Information

Another factor contributing to the public awareness and concern over property tax exemptions is the greater amount of information that is becoming available on this topic. Although various state legislative committees have periodically studied property tax exemptions, these reports were restricted to specific times and locations. As such, they appealed to a rather narrow audience.

Although there has been no major breakthrough on the data front, publication of Albert Balk's work, *The Free List,* has altered this situation. Balk may very well be one of the few to attempt to estimate the increase of property tax exemptions and to estimate, using whatever bits and fragments of data he was able to uncover, the overall magnitude of tax-exempt property.

Balk's accomplishment, however, lies not so much in the scope of his study or in any pioneering estimation techniques as it does in the fact that *The Free List* is a readily comprehensible work that has served to extend the audience for this topic beyond the usual tax expert and legislative committee. Much like Phillip Stern's *The Rape of the Taxpayer,* and to a lesser extent the work of Pechman and Ockner on income tax loopholes, *The Free List* presents a popularized treatment of a topic on which the average taxpayer may previously have had only passing or minimal interest. The "quasi-muckracking" tone adopted by Balk in places—his description of the Pan American building as the world's tallest tax exemption and his discussion of the tax-exempt consumer going through life using the services and activities provided by tax-exempt organizations—serve to arouse and heighten the average taxpayer's resentment against a tax system he regards as increasingly onerous.

This is not to say, however, that publication of *The Free List* has transformed a latent hostility into a crusade for reform. This is clearly not the case. Indeed, the overall magnitudes of tax-exempt property—however staggering they may appear—do not necessarily form the basis for a program of reform. Much of the exempt property, for example, represents holdings of the federal government, which are immune from state and local taxes; another sizable segment is the holdings of local governments themselves, which if made taxable would do nothing more than add to the tax rolls property that the taxpayer would have to pay for. In short, a thoughtful reading of *The Free List* might very well lead to the conclusion that property tax exemption is an area in which the room for invoking alternatives is relatively circumscribed—by law, by tradition, and by practice.

Nonetheless, if *The Free List* is unsatisfactory as an agenda or a blueprint for reform, it seems undeniable that it has served to crystallize what may have been a vague and ill-formed conception of the property tax exemption issue and made it more readily comprehensible for the general reader.

IV

ALTERNATIVE STATE OPTIONS

Fiscal Alternatives

Conceptually, the state has three approaches available to it for dealing with religious, charitable, educational, and other organizations seeking tax exemption. It can, of course, pursue the status quo approach—that is, continue to grant tax exemptions without providing reimbursement to local governments. In view of the numerous drawbacks to this approach, however, states may pursue either of two alternative strategies in dealing with the fiscal considerations inherent in the tax-exemption subsidy. While this section deals with alternatives to the tax-exempt technique, it should be borne in mind that few advocate wholesale repeal of the tax-exempt privilege. Whatever the drawbacks of this subsidy approach, it has been vigorously defended. Professor Kendrick, for example, states:

> In my opinion, the case for these conventional exemptions (religious, educational and charitable activities) of private property is strong. And indeed exemption from taxation is the only way that the government can help the institutions concerned without making them lost their independence of action. . . . On the other hand, the value of an exemption is concealed. But for the purposes thereby served, the very merit of an exemption lies in its hidden nature. No money is paid out of the treasury, no loss of revenue is computed, and no competition between institutions is engendered in the State legislature or the city council. The government simply refrains from taxation. As a result, each institution is helped, is on the same footing as the others, and is under no pressure to change its operations.
>
> The exemption, however, should be limited to the property used for the purposes served, and none that earn a profit to the institution or an individual should be included.[20]

State Reimbursement Via In-Lieu Payments

States can supplement their tax-exempt policy by reimbursing localities in whole or in part for the revenue loss due to tax exemption. This approach has several advantages, not the least of which is that it recognizes tax exemption as a political reality that is unlikely to be overthrown either quickly or generally. By means of partial or full reimbursement, the state could respond to the fiscal-deprivation argument legitimately advanced by at least those jurisdictions that are overburdened by the presence of tax-exempt institutions. Moreover, since state payments would go to the locality rather than to the institution, there would be no interference by the state in the activities of the tax-exempt recipients. This approach would thus avoid several of the serious pitfalls that have effectively stood in the way of proposals to do away with the tax-exempt device and to replace it with a program of direct state subsidies to the recipient institutions.

If the state government were to undertake a program of direct payments to local governments, two options would present themselves. By far the more difficult method would be for the state to attempt to reimburse either dollar-for-dollar or some specified share of the revenue foregone by the locality. Under this procedure, the value of the tax exemption would have to be calculated, and while this is the least troublesome aspect, some arbitrary and difficult decisions regarding proper valuation would have to be made. The more basic stumbling block would be the division of benefits between state and locality. Presumably, the state would finance those benefits from the tax-exempt organization that go to residents beyond the local area while the locality would "pay" through tax exemption for those benefits consumed by local residents. The measurement of public benefits is not easily accomplished, however, and the difficulties involved would be significant for organizations performing many functions that qualify for exemption and because of the great variety and multiplicity of organizations and activities that presently receive tax-exempt status.

All of this is not to say that such a state payment program is impossible, on a theoretical basis. The real question is whether as a practical matter such a program would be workable and, if so, whether the necessary compromises and arbitrary resolution of disputes would in fact yield a very precise rendering of state versus local sharing of the benefits that are associated with the tax-exempt property or operation.

Recently, Rountree and Associates developed a methodology that illustrates the type of calculations necessary for a state reimbursement program of this type.[21] To determine the state payment, Rountree and Associates developed two concepts—a revenue capacity factor (RCF) and a payment in lieu of tax factor (PILT). To develop the RCF, the following data are needed for each taxing jurisdiction: (1) the acreage of each taxable parcel of real property, (2) the gross square footage of all improvements to taxable parcels, (3) the acreage of each tax-exempt parcel of real estate, (4) the gross square footage of all improvements to tax-exempt parcels, and (5) the portion of total property tax revenues accruing separately to land and improvements.

To derive the RCF for each jurisdiction, the total revenue generated by taxable land is divided by the total square footage of taxable land, giving the revenue capacity factor for land. As a second step, a revenue capacity factor for improvements is calculated by dividing the total revenue generated by improvements by the total gross square footage of taxable improvements.

This gives an average value on a communitywide basis for land and improvements for all taxable property. Since it is calculated on a square-footage basis, each of these average values—for land and improvements—can be applied to the square footage of tax-exempt property to yield a revenue raising potential for such properties. As Rountree and Associates state:

> The Revenue Capacity Factor represents a standard measurement, on a community-wide basis, of the revenue generating ability associated with any single square foot of land or improvement, taxable or tax-exempt, in each individual jurisdiction. On this basis, the revenue capacity factors

may be applied to tax-exempt land and improvements to determine their potential revenue generating ability if not exempt. It should be noted that the revenue figure generated by the formula is essentially equivalent to the average full value of the property tax which would normally be levied on the parcel were it taxable.[22]

The second step in this overall procedure is to develop the payment due by the state. For this component, Rountree and Associates use six types of local expenditures as reflecting "the effective cost to each jurisdiction for providing certain vital functions whose benefits accrue to all real property in the locality, whether taxable or tax exempt . . . .". These expenditures are general administration, assessment of taxes, administration of justice, crime prevention and detection, fire prevention and extinction, and maintenance of buildings and grounds. The sum of these six items is then divided by the total property tax revenue and the figure further refined by multiplying this ratio by the ratio of total property tax revenue to total local source revenue. This is termed the payment-in-lieu-of-taxes coefficient. If the exempt property is also valued, then the PILT coefficient can be applied to this value and establishes the limit of in-lieu payments to the particular locality.

This approach to the state reimbursement issue can rest here and thus constitute a state payment solely for the presence of tax-exempt property. One troublesome aspect of this, however, is that there is no real assurance that all communities in the state are in need of such a program. Thus, a strict state reimbursement program—whether determined in the fashion suggested by Rountree and Associates or by some other methodology—is subject to the lingering question, "Is this the best way to spend the additional state money?"

Because the revenues foregone by property tax exemption may not be a pressing problem for all localities in a state, or because of the variations in the degree to which particular jurisdictions are affected by the tax exemption issue, it may be desirable to attach a second objective to a state reimbursement program. The approach above can be carried further and made into a state reimbursement program for tax-exempt property that is unconditional and equalizing as well. Under this approach, localities would share in a program that allocated state funds not only on the basis of exempt property valuations—which would establish the reimbursement nature of the program—but other factors designed to compensate for local differences in program needs or financial ability.

Admittedly, such an equalizing program would not yield a precise rendering of state payments to statewide, as opposed to local, benefits of tax-exempt organizations. Yet, the latter would have the distinct advantage of providing the state legislature with a program design that offered the opportunity of at least assuring that state payments be distributed where they are most needed. Although some would argue that all types of tax-exempt property mandated by the state should be compensated for, this argument is of even greater force for those local jurisdictions where the presence of tax-exempt organizations presents an "overburden" situation or where the already meager local fiscal resources would be further eroded by a mandated state exemption. Thus, while tax-exempt property in the richest local jurisdiction would be compensated for by such a state program, the same type of property would bring even greater state compensation to the poorer local jurisdiction, if an equalizing measure of local ability were added to the formula.

To be sure, it seems reasonable to expect that representatives from wealthier districts would be less receptive to this type of state compensation program than would officials of the poor jurisdictions. Yet, the opposition of the richer communities should be substantially blunted by two additional considerations. Most obvious is the fact that while richer jurisdictions receive less per parcel of tax-exempt property than their poorer counterparts, they still receive something over and above what they are presently getting from the state. A second sweetener would be the unconditional nature of the state assistance. The greater flexibility and local discretion permitted by this approach may be sufficient to induce representatives of the more affluent localities to accept the imprecise nature of the state reimbursement.

Regardless of whether the state were to take the more precise reimbursement program or the unconditional-equalization approach, the major benefit would be the increased responsibility of the state in granting exemptions. A highly desirable by-product would be the much greater availability of tax-exempt property valuation data—data that, due to the nature of the state program, would be more current and comparable than much that is presently available.

State Authorization of Service Charges or In-Lieu Payments

An alternative policy option available to state government is to permit local governments to impose service charges on or to negotiate voluntary payments in lieu of taxes from the recipients of the state-mandated property tax exemption. This approach differs fundamentally from the in lieu payment approach in that the value of the tax-exempt provision to the recipient—while fully maintained under the state payment program—is eroded by the extent to which local governments impose service charges or in-lieu payments.

Both the imposition of local service charges and in-lieu payments accomplish the objective of reducing the revenue foregone by the local government due to tax exemption. Thus, they are both fiscal instruments designed to recapture revenues. Yet, they differ in several important respects. Local service charges are most appropriate where the recipients of the service can be reasonably well identified and the prices for the service can be collected easily and where substantial waste would occur if the service were provided free.

In essence, service charges are a mechanism geared to a precise rendering of costs and prices. In practice, however, there is a restricted scope for service-charge financing. To be sure, new types of service charges or social waste prevention taxes can be conceived of. The difficulty is that to impose new and different charges would require additional administrative costs which may very well reduce significantly the net additional revenues that accrue to local governments. This is particularly true since such new service charges, if restricted solely to tax-exempt organizations, would yield relatively little in additional revenues, even disregarding costs of administration. Administrative costs can be expected to be relatively high since the use of new charges would necessitate almost continual analysis and negotiations, sometimes on an institution-by-institution basis. If such charges were levied community wide, two disadvantages would have to be recognized: the loss of the tax-deductibility privilege for federal individual income tax purposes and the introduction of an element of regressivity into the sharing of costs for public programs. Use of the more standard type of user charge—water, trash removal, and so forth—would, of course, largely avoid the administrative complexities. Even with some of the more traditional charges, however, the problem remains that it is difficult to determine on what basis a particular institution benefits and should pay. Police and fire protection, though not water and sewerage, would seemingly necessitate use of some arbitrary allocation factor—per capita costs, per acre, or per $1,000 assessed valuation.

These more standard charges, while applicable to certain services, would not appear to be adequate if large amounts of tax-exempt property pose a severe fiscal drain for a particular jurisdiction. As the Report of the Property Taxation Committee of the National Tax Association-Tax Institute of America noted:

> At the very least these charges might be applied to sewer drainage, sewage treatment, garbage and trash collection and disposal in addition to water service. Some local governments have even proposed a charge for fire and police protection, and street maintenance. However, even if charges were required for all of these services the total would fall far short of a tax because they do not include contributions for schools, welfare and dozens, perhaps hundreds, of the local public services.[23]

This is not, of course, a particularly startling conclusion. Service charges are conceptually a pricing mechanism designed to produce a more efficient or rational allocation of scarce economic resources. They are applicable to specific services as opposed to being general tax instruments, though obviously, they do accomplish a revenue-raising objective. In actual practice, of course, the use of service charges may be mainly for their revenue potential rather than for their resource-allocation effects. Moreover, the connection between the charge and a particular cost may be tenuous, at best. Where these conditions hold, the service charge is in fact being used inappropriately—as a supplement to the general local tax base. Where appropriately applied—as a charge for a particular service and equal to the cost of that service—the use of charges is best considered as a partial replacement of revenues foregone by the tax exemption.

Service charges have been utilized by various jurisdictions to recapture at least some of the revenues foregone due to tax exemption. A water and sewerage charge is imposed on such property in both Denver and Colorado Springs. In 1969 Milwaukee adopted a sewer service charge against tax-exempt properties other than elementary and secondary schools. Pittsburgh levies what opponents call a "sick tax," otherwise called an "institution tax" of $6 per $1,000 of assessed valuation affecting exempt properties such as hospitals, nursing homes, colleges, universities, veterans' posts, recreational centers, and other organizations that charge fees to the public.[24]

In short, authorization by the state of standard type user charges would indicate that the local fiscal problem is not really particularly severe, or if it is, that the authorized remedy is not really adequate. Authorization and imposition of service charges merely reduces the amount of the subsidy to the recipient institution. The state, which mandates the exemption, does not provide financial assistance to reduce the amount of the subsidy. Nor can it be claimed that the residual subsidy—after the imposition of service charge fees—is a more precise measure of the benefits provided by the tax-exempt institution to the locality. Rather, a part of the costs are simply shifted from the locality to the tax-exempt recipient.

Very much the same types of considerations are as applicable to voluntary in-lieu payments as they are to service charges. Both devices are, of course, designed to reduce the costs to the locality where the tax-exempt property is located. Yet, where service charges are designed to recover the costs of providing a particular service consumed by the tax-exempt recipient, in-lieu payments have more of a "voluntary payment" character. Such payments are not specifically geared to a particular service or recapture of a specified portion of costs incurred by the locality but are rather a negotiated payment between the local jurisdiction and the tax-exempt organization.

Perhaps the best known voluntary in-lieu payments are those between Harvard University, M.I.T., and the City of Cambridge, which has been receiving payments based on the assessed valuation of land (not buildings) since 1928. The initial agreement was such that the two universities made payments for 20 years on any property removed from the tax list after 1928—an agreement that was renewed in 1948, 1968, and annually thereafter. In the field of higher education, the voluntary in-lieu approach is fairly frequently used. A 1969 study by the American Council of Education indicated that 30 percent of 318 respondents made such payments to local governments. A more limited study of 33 colleges conducted by Yale University and the City of New Haven revealed that half of these institutions made some payment in lieu of taxes.

Obviously, the negotiated payment will not result in a full recapture of costs to the locality since this would be a voluntary surrender of the value of tax exemption by its recipient. The full costs are also unlikely to be recovered because the city or locality usually has relatively few trading cards with which to negotiate an in-lieu payment. To be sure, the tax-exempt institution may prize good relations with city hall and appreciate that local officials can become difficult over plans for institutional expansion. Nonetheless, the locality cannot challenge or overthrow the mandated exemption.

Like service charges, the state is not involved in the financing arrangements of in-lieu payments, aside from their authorization, and the result of any such payments would simply be to reduce the revenues foregone by the locality, with little reflection of the distribution of benefits between local and non-local residents. State authorization of either local service charges or in-lieu payments offers, at best, a partial recovery of the revenues foregone by the locality due to tax exemption. Neither approach involves any state financing to distinguish between benefits accruing to residents versus non-residents. Rather, the decrease in the revenues foregone by tax exemption is accomplished by additional payments from the institution to the locality. As such, service charges and in-lieu payments amount to a partial reduction in the value of the tax-exempt privilege to the recipient organization.

The use of either service charges or in-lieu payments by local governments is not likely to go unchallenged by the exempt institution. Regardless of their nomenclature, recipients of the tax-exemption privilege will rightly view such payments as a reduction in the value of their tax-exempt status. Moreover, such charges or payments may be considered to be the "foot-in-the-door" to full taxation since once the "right" of tax exemption is violated, there is no clearly defined point at which the level of charges or payments ought to terminate. In addition, those communities seeking the authority to impose such payments on tax-exempt institutions to improve their revenue-raising capacity, may also be those communities most in need of the types of services provided by philanthropic organizations. Since the increased payments by the institution would seemingly be paid for from their operating revenues, this would curtail their activities, particularly if the institution's finances are tight. Nor can it be ignored that the institution's board, supporters, and users of services are well placed, well organized, and possess political clout in opposing such revenue measures, while those advocating additional payments by tax-exempt institutions may be fragmented. Legal impediments may also complicate the efforts of those seeking increased revenue contributions from tax-exempt institutions. Because of these several factors, then, recipients of the tax exemption can be expected to defend their status.

Administrative Alternatives

There are a number of possible measures that would alleviate the difficulties posed by the traditional tax-exemption. Among the most significant of these are (1) periodic or annual renewal of the exemption privilege, (2) regular assessment of tax-exempt property, (3) compilation of tax-exempt property by taxing jurisdiction and (4) publication of findings, and (5) local home rule for determining exemptions, with state safeguards.

Each of these measures offers at least the potential for ameliorating one or more of the defects of the traditional property tax exemption technique. It should be emphasized, however, that while these measures are independent of the fiscal options that the states may consider, they are compatible with the previously discussed fiscal alternatives.

Periodic or Annual Renewal

One of the more long standing criticisms of the property tax exemption is that once granted, it is rarely, if ever, reviewed. As such, the property tax exemption carries with it a certainty and a permanence that is unparalleled in all other sources of governmental subsidies. This certainty, however, is achieved at a considerable loss of flexibility to state and to local policy makers. Because of the lack of periodic or annual review procedure, there is little opportunity to determine whether this form of subsidy is compatible with or in conflict with the aims and objectives of current governmental policies. Stated alternatively, the merit of periodic or annual review of tax-exempt property would be its ability to reassess in light of current rather than past purposes the legitimacy of the property tax exemption. It would, in effect, put back the property tax exemption into the budget calculus and thus extend the scope of items that are "controllable."

With a system of annual or periodic state government review, it can also be expected that there would be greater scrutiny of the activities of recipients of the tax-exempt status. Such scrutiny need not be subject to the charge of political interference. Rather, it can be restricted to providing the assurance that the exempt institution or organization is in fact providing the services and activities for which the original grant of exemption was provided. To the extent that review goes beyond this objective, the likelihood and validity of a charge of political interference becomes more germane.

Local Option, With State Safeguards

A second reform would go to the heart of the division of authority between state and local governments. At present, the state mandated non-reimbursement exemption has the state government as the "giver" while the local government in which the exempt property is located bears the cost and is therefore the "payer." With this proposal, the breach of state authority and local responsibility would be closed by the state's transferring its authority to grant tax exemptions to the local sector. By placing this authority and responsibility together at the local level, a more accurate determination of benefits and costs may be achieved.

The local option proposal, however, would necessitate the imposition of certain state safeguards to assure that the statewide interest in property tax exemptions was maintained. For example, the state would have to enumerate either specific organizations or broad areas of activities where local governments might apply the grant of tax exemption. Quite obviously, the state cannot sanction the exemption of one religious group while having a second such organization made taxable.

More importantly, however, the state would have to protect against the possibility of competition among localities either to attract what might be considered the more "profitable" or prestigious types of religious, educational, and charitable organizations or to freeze-out "undesired" institutions, such as homes for the aged and halfway houses. It is not impossible that some educational institutions may shop around among local communities for the best tax offer when they are considering the expansion of their physical plant and facilities. To have this decision influenced by tax considerations would, it would seem, be less than optimal from the state's viewpoint.

This is not to say that a system of local option to grant property tax exemption is not feasible. It is merely to point out some of the potential difficulties. At a minimum, it seems clear that states must assure that all organizations performing the same type of activity—whether it be religious, educational, or charitable in nature—be treated equally by a particular local government, though not necessarily by all local governments. Whether all such religious, educational, and charitable organizations would favor such a system is another question. The church-state issue would presumably preclude any meaningful option being passed to localities, though on church-related questions—such as the tax treatment of parsonages and other properties owned by the church but not used exclusively for religious purposes—local authority and discretion would seemingly be enhanced.

Even if these difficulties were surmounted, it must be recognized that this authority to tax religious, educational, and charitable institutions would be a mixed blessing for local officials. Such organizations and activities retain a place of esteem in the public's eye because of their benevolent nature; the authority to render taxable the previously exempt property of organizations may in practice turn out to be a lesser enhancement of local decision making powers than it is intended to be in theory.

Systematic Assessment and Publication of Findings

No study of the question of tax-exempt property can proceed very far without the data limitations becoming evident. To be sure, this is the constant lament of researchers and policy makers as it is rarely possible to come up with the precise statistical information needed for specific purposes. The question of property tax exemption must surely set some sort of record for the paucity of current, comparable data. Indicative of this is that the best and most recent data available are from the Census Bureau for 1971. Even here, the data are available for only 17 states plus the District of Columbia and are not strictly comparable among this limited number of states.

If the taxpayer is to be kept informed, it is essential that tax-exempt property be regularly assessed, that it be classified by type of exemption and by taxing jurisdiction, and that such findings be published. This package of administrative reforms would seem to be the minimum necessary for intelligent discussion and evaluation of the issues by the taxpaying public and its elected officials. This is the recommendation made by the Advisory Commission on Intergovernmental Relations in 1963:

> In order that the taxpayer may be kept informed, each State should require the regular assessment of all such tax exempt property, compilation of the totals for each type of exemption by taxing districts, computation of the percentages of the assessed valuation thus exempt in each

> taxing jurisdiction and publication of the findings. Such publication should also present summary information on the function, scope and nature of exempted activities.[25]

More than a decade later, this recommendation remains applicable to a problem that has grown in significance and continues to provoke public concern.

Footnotes

1. "The Erosion of the Ad Valorem Real Estate Tax Base," Volume XI, No. 1, National Tax Association, 1973, p. 12.

2. Harold B. Meyers, "Tax Exempt Property: Another Crushing Burden for the Cities," *Fortune* (May 1, 1969), p. 79.

3. Alfred Balk, *The Free List, Property Without Taxes* (Russel Sage Foundation, 1971).

4. Ibid., pp. 18-19.

5. Rountree and Associates, *Real Property Tax Exemptions and Relief*, Vol. II, Table A3-1.

6. Ibid., Table A3-6.

7. Ibid., Table A3-11.

8. Vincent A. Schmit, "Limitation of Property Tax Exemptions," Proceedings of the 61st Annual Conference on Taxation, National Tax Association, San Francisco, 1968, p. 237.

9. M. Slade Kendrick, "Property Tax Exemptions and Exemption Policies," Proceedings of the National Tax Association, Philadelphia, 1958, p. 87.

10. "Alternatives to the University Property Tax Exemption," *Yale Law Journal*, Vol. 83, No. 1 (November 1973), pp. 183-4.

11. Ibid., p. 189.

12. John L. Knapp, *Virginia Issues: The Real Property Tax*, Tayloe Murphy Institute, University of Virginia Graduate School of Business Administration, (April 1974), p. 23.

13. *Yale Law Journal*, op. cit., p. 183.

14. Meyers, op. cit., p. 77.

15. Gregory H. Wassall, *Tax-Exempt Property: A Case Study of Hartford, Connecticut* (John C. Lincoln Institute, 1974), p. 57.

16. Schmit, op. cit., pp. 237-8.

17. Ibid., p. 237.

18. Urban Observatory, "City Taxes and Services: Citizens Speak Out," *Nation's Cities* (August 1971), p. 9.

19. Ibid.

20. Kendrick, op. cit., p. 88.

21. Rountree and Associates, op. cit.

22. Ibid., p. 111.

23. "The Erosion of the Ad Valorem Real Estate Tax Base," op. cit.

24. Balk, op. cit., p. 137.

25. Advisory Commission on Intergovernmental Relations, *The Role of the States in Strengthening the Property Tax*, Vol. I, A-17 (Washington, D.C., 1963). p. 11.

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